Delivering on Customer Commitments

Canadian National 1997 Annual Report

Canadian National Railway Company (CN) is Canada's largest railway system, with more than 14,500 route miles of track in Canada and approximately 750 route miles of track in the United States.

CN's rail network serves all five of Canada's major ports: Halifax, Montreal, Thunder Bay, Prince Rupert and Vancouver, and includes strategic connections to the United States through the Chicago gateway, Detroit and other major cities.

Contents

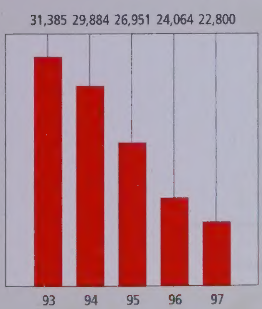
2	Introduction
3	Chairman's message
4	Letter to shareholders
6	Delivering on customer commitments
14	CN today
16	President's awards for excellence
17	Financial section
56	Pension plan
65	Board of directors
66	Officers
67	Shareholder information

FINANCIAL AND STATISTICAL FIVE-YEAR SUMMARY

$ in millions, except per share data, or unless otherwise indicated	**1997**	1996	1995	1994	1993
Financial results					
Revenues	**$ 4,352**	$ 3,995	$ 3,954	$ 4,165	$ 3,829
Operating expenses excluding special charges	**3,545**	3,385	3,514	3,708	3,627
Special charges	**–**	381	1,453	–	49
Operating income (loss)	**807**	229	(1,013)	457	153
Operating income excluding special charges	**807**	610	440	457	202
Interest expense – net	**118**	114	198	196	198
Other income	**57**	27	100	36	12
Income (loss) from continuing operations	**421**	836	(1,092)	269	(59)
Income (loss) from continuing operations excluding special charges	**421**	1,217	361	269	(10)
Capital expenditures	**577**	496	326	539	442
Earnings (loss) per share from continuing operations	**4.95**	9.85	(13.57)	3.36	(0.74)
Earnings (loss) per share from continuing operations excluding special charges	**4.95**	12.39	4.49	3.36	(0.13)
Other statistical highlights					
Rail operating ratio excluding special charges *(%)*	**81.5**	84.7	88.9	89.0	94.7
Route miles *(includes Canada and the U.S.)*	**15,292**	17,124	17,918	18,414	18,851
Carloads *(thousands)*	**2,547**	2,315	2,295	2,354	2,182
Gross ton miles *(millions)*	**228,353**	208,328	204,143	211,805	193,797
Revenue ton miles *(millions)*	**119,534**	107,470	105,487	109,004	98,650
Rail employees *(average for the year)*	**22,800**	24,064	26,951	29,884	31,385
Diesel fuel consumed *(Canadian gallons in millions)*	**272**	259	256	266	250
Average price per Canadian gallon *(dollars)*	**$ 1.23**	$ 1.22	$ 1.08	$ 1.03	$ 1.04

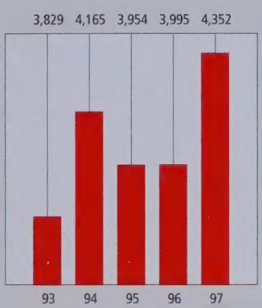
Employees

Average for the year



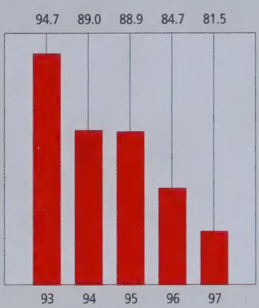
Revenues

Dollars in millions



Operating ratio (%)

Excluding special charges



In 1997, CN entered the next phase of its turnaround plan – building disciplined, profitable top-line growth. To achieve this, we are focused on working with our customers to improve their competitive position. When our customers succeed, we succeed.

By leveraging CN's three unique strengths – a continent-spanning network, industry-leading technology and a performance-driven culture – we are creating value for our shareholders by delivering on customer commitments.

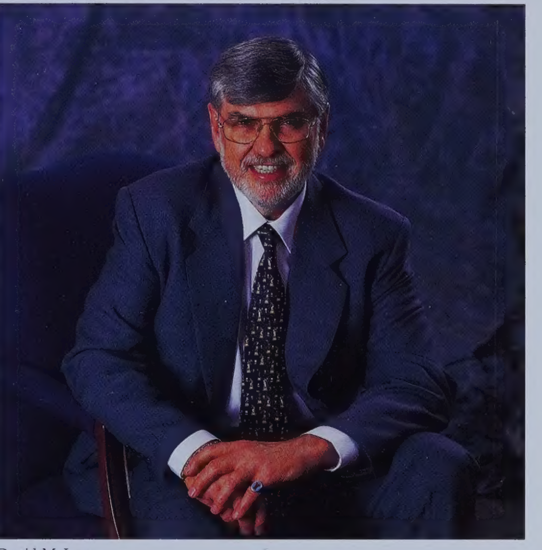
CHAIRMAN'S MESSAGE

We have just completed another extraordinary year of achievement at Canadian National. It was a year of tremendous growth – a testimony to the success of the initiatives begun just a few years ago when we became a public company.

CN's 1997 record performance is also due in large measure to the skills and hard work of our people. At the management level, our leaders displayed the vision and strength to guide CN confidently into the next century. CN employees continue to demonstrate that dedication and teamwork bring results, and it is exciting to see such energy and focus.

We are serving our customers better than ever. We continue to gain on our U.S. counterparts in terms of efficiency and profit. We are getting closer to achieving our goal, which is to be the safest railway in North America. As I look around CN, I am struck by this thought: we have come a long way in the past few years, but this is just the beginning!

As we approach the millennium, CN has some very creative plans for the future – it is a very dynamic company, well positioned for the 21st century. I especially appreciate the confidence and support that our shareholders have shown as they continue with us on our journey.



David McLean

Our board of directors has good reason to be proud. They have spent considerable time and energy helping set the course we are on today. As chairman, it is gratifying to be part of such an extraordinary effort, and I am grateful to each one of our directors for their total commitment to the new CN. We are all dedicated to creating the best possible value for our shareholders.

Sincerely,

David McLean

David McLean
Chairman of the Board of Directors

TO OUR SHAREHOLDERS

Nineteen ninety-seven was a very successful year – the best in our history. Once again, we achieved or surpassed virtually every financial goal we set for the company. We significantly improved our safety performance. On every front, we continued to make headway in our drive to position the company to successfully compete in the 21st century.

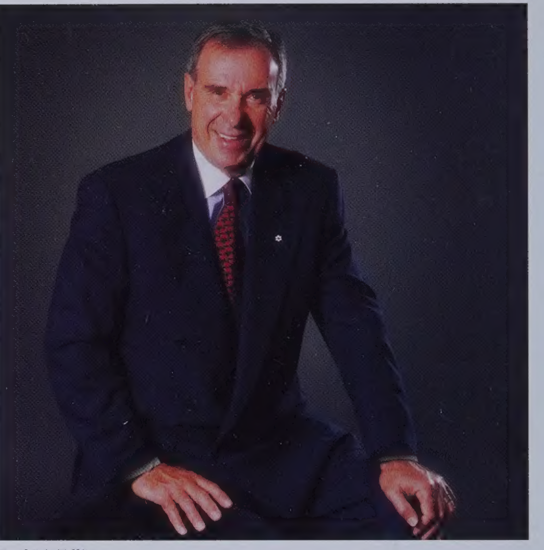
But make no mistake: CN is a work in progress. And we are far from finished.

Financial performance in 1997 was outstanding. Income from continuing operations was $421 million or $4.95 per share, an increase of 42 per cent over last year's adjusted income from continuing operations of $296 million or $3.49 per share. Operating income for 1997 was $807 million, compared with 1996 operating income, excluding special charges, of $610 million.

Revenues for 1997 were $4,352 million, a 9 per cent increase over revenues of $3,995 million in 1996. This revenue gain, on a per cent basis, led all major North American Class I railroads. Total 1997 operating expenses were $3,545 million, a 5 per cent increase over 1996 operating expenses, excluding special charges. In 1997, labour and fringe benefit costs increased by only $50 million and material costs by only $19 million, despite severe winter weather conditions in the first quarter. We again surpassed our operating ratio goal, bringing it down to 81.5 per cent for 1997, a 3.2-point improvement over the 1996 operating ratio, excluding special charges, of 84.7 per cent. Our goal for 1997 was 83 per cent.

While we at CN are extremely proud of our performance in 1997, the job is not done. Our operating ratio is still several points behind the leading North American railroad. CN's labour productivity is just 60 per cent of U.S. Class I railroads. And the competition's performance continues to improve.

But we are very confident. We have a plan, and it's working. The turnaround phase, with its focus on cost cutting, is complete. We are continuing to drive down costs, but our emphasis now is on growth. Profitable, *disciplined* top-line growth. At CN, we are achieving this by constantly developing new ways to help our customers succeed in trade. And we are absolutely determined to accomplish this in ways that deliver increased value to our shareholders.



Paul M. Tellier

In 1997, we streamlined the CN management structure to improve responsiveness to our customers and make better use of our assets. We removed a layer of senior-level management and grouped our business units according to factors that most affect our customers: service needs and equipment requirements. We consolidated management and coordination of CN Intermodal and Automotive, our most time-sensitive businesses. We grouped Grain and grain products with Coal, sulphur and fertilizers because of similar service needs and equipment requirements. We formed the Merchandise business unit to coordinate management of Industrial and Forest products and focus on those portions of the business with the most widely varying load sizes (often single cars), routes and schedule requirements. Our new structure enhances coordination between marketing and operations, limits competition between the business units for assets, and improves efficiency and service quality. Simply put, it helps us serve customers better.

Our ongoing efforts to implement shipment management and a scheduled railroad for our customers made significant strides forward in 1997.

We successfully completed implementation of our Service Reliability Strategy (SRS) and Operating to Plan (OTP) initiatives and continued expanding on the capabilities they provide.

We are now working on the next steps: Customer Advanced Shipment Information (CASI) will connect customers directly with SRS and will allow us to respond to their shipment needs in advance. Balanced scheduling combines partnering with customers through SRS and OTP to smooth out peaks and valleys of demand, improve service offering and enhance asset utilization. In each of these initiatives, our goal is, above all, to implement the capability to manage shipments to customer requirements, rather than CN requirements.

In 1997, we moved to protect business potentially affected by industry consolidation south of the border. The acquisition of Conrail, as first proposed by CSX Corporation and Norfolk Southern Corporation, could have affected our franchise in the U.S. Northeast, particularly at the Buffalo and Massena gateways, where we move newsprint, metals, plastics and petrochemicals to markets across the border. Our agreement with these carriers protects the interests of our customers by expanding the effective reach of their commodities into the northeastern U.S. market.

Yet to ensure the success of our customers in their end markets, we must do more than simply safeguard CN's existing position in North America. Their future prosperity lies in the rapidly growing trade corridor from the U.S. upper Midwest to the Gulf of Mexico. That is why we have entered into a definitive merger agreement under which CN will acquire all of the common stock of Illinois Central – "The Main Line of Mid-America" – to create, subject to regulatory approvals, a seamless, three-coast, single-line service for shippers at just the right time in the history of continental trade. This is a partnership for growth: growing revenues and growing shareholder value. It is about building a railway for the 21st century.

Safety is the biggest concern I have, wherever I go, every day. Safety is a core value at CN, and I am pleased to report that we are now number two in safety performance among North American railroads, one step closer to our goal of being number one. In the past year, we have worked closely with all seven CN unions to implement a comprehensive safety training program. Working together, we are focusing beyond rules and regulations. We are emphasizing behaviour-based initiatives to instill the attitude "safety is my personal responsibility" in each and every employee. The results of our collective efforts in 1997 were very encouraging: we decreased accidents by 27 per cent, injuries by 24 per cent.

Our employees deserve credit for CN's tremendous overall performance. CN's culture has been transformed. Everyone here knows their performance is critical to serving our customers better, achieving our business goals and building shareholder value. CN's workforce is one of the most highly skilled and dedicated in the industry, and our senior management team has done an excellent job, leading the achievement of virtually every objective we've set for the company so far.

I see an extremely bright future for CN. We are always seeking ways to improve our market position and the reach of our network through new alliances with other carriers. More and more, we are becoming a truly North American railway.

I want to thank our shareholders for their continued support in our second year as a publicly traded company. We are more dedicated than ever to becoming the best railway in North America.

Yours sincerely,

Tellier

Paul M. Tellier
President and Chief Executive Officer

CN's key strengths

A continent-spanning network

Canadian National operates North America's only transcontinental railway, extending from Halifax, Nova Scotia, to the ports of Vancouver and Prince Rupert on Canada's west coast. Our core network is the most northerly of any on the continent, with direct access to Canada's vast reserves of natural resources. We have also built a strong presence in Chicago, gateway to America's heartland, complementing our ability to directly interchange traffic with all Class I railroads, at state-of-the-art intermodal and transloading terminals.

To deliver on customer commitments, we are exploiting CN's strengths as one of North America's most efficient long-haul networks to help customers reach new markets. We are reaching beyond the CN network to help our customers compete – creating alliances with other carriers and providing value-added services. And we are continuing to improve our network's efficiency in ways that serve the needs of customers and communities that depend on us.

Competitive advantages

CN's western service corridor extends from Canada's west coast to the Great Lakes region. We have several key advantages in the west. CN's track grades through the Rocky Mountains are lower than any other railway, which speeds our service, saves fuel and reduces locomotive, car and track maintenance costs. We are the only Canadian railway to serve two ports on the west coast, Vancouver and Prince Rupert. CN has exclusive access to Prince Rupert, the closest North American port to Asia. And CN's west coast-to-Chicago corridor is the shortest route to the U.S. Midwest for British Columbia forest products.

Intermodal is CN's fastest-growing business segment. In the west, CN's advantages uniquely position it to capture intermodal traffic from Asia to the United States. Vancouver's Deltaport Terminal, opened in 1997, provides shippers with highly efficient, high-volume loading capabilities and the closest intermodal facilities to much of Asia.

CN enhanced access to strategically important Chicago with a number of

Enabling trade in the 21st century

Coal for international markets

Customer: Coal shippers

Product: Metallurgical coal

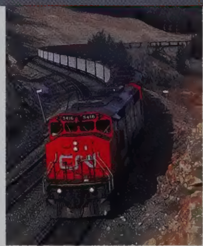
Situation

Japan is the largest market for Canadian coal. Canada and its major coal competitor, Australia, are about the same sailing distance from Japan. However, Canada's premium metallurgical coal deposits are three or more times as far from port as Australia's. This puts intense pressure on the efficiency of the rail system.

CN works in partnership with its customers to ensure that the delivered costs of their products remain competitive in the world marketplace.

Customer challenge

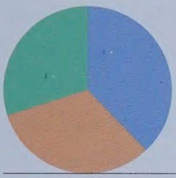
Develop a highly reliable, efficient system to transport coal from the mines to the ports for export. International metallurgical coal markets are highly competitive. There is a need to deliver product at the lowest possible cost. With logistics accounting for about one third of the total price of the coal, efficient logistics is of paramount importance. Transportation plays a critical role for Canadian coal producers to overcome their geographical disadvantages.



CN solution

A highly efficient, reliable transportation corridor from the customers' mines to western Canadian ports. CN's investments in new high-

1997 well-balanced destination mix



U.S. domestic and crossborder	38%
Overseas	32%
Canada domestic	30%

initiatives in recent years. We improved bridges and enlarged tunnels through the Rockies to accommodate doublestack container trains. We formed a strategic alliance with Wisconsin Central to give us direct access to the Chicago gateway. We opened CN's new Gateway Intermodal Terminal just south of Chicago to provide high-volume unloading capabilities at the heart of the U.S. interstate highway system.

In the east, CN's network extends from Halifax to Chicago, directly linking numerous major cities, including Montreal, Toronto and Detroit.

Competitive advantages in this region include exclusive CN rail access to Halifax, the closest port on the eastern seaboard to Europe. Unlike other eastern ports, Halifax can accommodate the world's largest vessels, fully loaded. This is becoming more important strategically as the size of vessels in intercontinental service continues to increase. Vessels can unload part of their cargo first at Halifax, lessening their draught and enabling them to enter other east coast ports. With exclusive access to the first port of call, CN can provide a significant advantage to customers with time-sensitive cargo.

CN's St. Clair Tunnel has been instrumental in enhancing the company's competitiveness in the east. With its completion two years ago, CN reduced transit times by up to 24 hours and became the only Canadian railway with a double-stack capability from the Atlantic to Chicago. The tunnel can accommodate all trains, including high-capacity automotive tri-level and doublestack intermodal cars.

Extending our reach

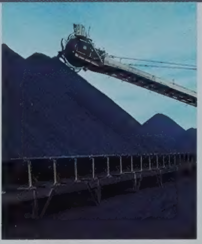
We are taking customer shipments beyond the considerable reach of the CN network through strategic alliances with partners in the rail industry. For example, a joint marketing and operating agreement with CSX will help grow transborder trade in key north-south corridors. New marketing and operating agreements with BC Rail will decrease transit times and enhance forest product customers' access to new markets. Agreements with Norfolk Southern and Wisconsin Central further extend the reach of CN's customers.

Route: Central Alberta to the Port of Vancouver and Port of Prince Rupert, British Columbia

capacity aluminium cars help meet two objectives – coal producers' needs for cost-efficient transportation and CN's drive for better asset utilization. These lightweight aluminium gondolas carry up to 6 per cent more coal per car. Trains can operate with 10 per cent more cars per train. In combination with CN's heavy-axle program (which increased maximum allowable track weights), these initiatives have generated productivity gains of up to 28 per cent in coal transportation.

A two-person CN road crew, riding efficient, high-horsepower locomotives, can spot 110 high-capacity rail cars for loading. Upon completion of loading, the customer's computer will compile vital statistics for the train and transmit the data electronically to CN's Customer Support Centre in Winnipeg, Manitoba, for waybilling.

During the journey, CN's Service Reliability Strategy (SRS) system will monitor progress of the train, measuring against planned operation and targeted arrival. The SRS system will provide the coal terminal with an estimated arrival for the shipment,



using data from trackside scanners and activated by automatic equipment identification tags on the individual cars. Once at the

Another significant way we're extending our reach and serving customers better is through transloading – taking shipments to destinations such as Chicago, Toronto or Detroit and transferring them to motor carriers for final delivery. CN's network of 148 company-owned and third-party transloading facilities is expanding constantly.

CN is also developing strategies to expand its role in shippers' logistics networks. Increasingly, we're working with customers to offer value-added transportation capabilities – warehousing, inventory management and distribution services.

Improving network efficiency

A more efficient CN network means better and more competitive service for our customers. Our network rationalization plan is transforming CN into a more efficient long-haul, high-density core railway, connected to a low-cost, growth-oriented feeder network.

The sale of CN low-density lines to short-line railways has revitalized rail service to local customers, industries and communities.

Since 1992, our network rationalization plan has covered more than 10,000 kilometres (6,500 miles) of secondary lines as of year end 1997. Our plan is to rationalize a further 4,000 kilometres (2,500 miles) of track by 1999.

In 1997, CN sold or discontinued 2,400 kilometres (1,500 miles) of track from its network. Major short-line transactions in 1997 included the sale of the 485-kilometre (301-mile) Intercolonial Railway line in New Brunswick and Quebec to short-line operator Quebec Railway Corporation and the sale of 449 kilometres (279 miles) of track in northwestern Saskatchewan to OmniTRAX. CN also sold 1,025 kilometres (640 miles) of track in northern Alberta and the Northwest Territories to RaiLink, Ltd., and leased the 63-kilometre (39-mile) Hagersville and N&NW line in southern Ontario, also to RaiLink, Ltd.

By combining CN's long-haul efficiency with the short lines' customer-focused local service, CN is able to convert its secondary lines into a low-cost growth-oriented feeder network. The overall result: a superior ability to deliver on our commitments to customers and more profitable operations for CN.

terminal at the Port of Vancouver or Port of Prince Rupert, the coal moves to a designated stockpile using automated unloading technology. When vessels arrive at the terminal, coal is taken from the stockpile and loaded onto the ship for transport to steel mills in Japan.

Customer results

Competitive access to international trade. CN's superior network, expertise and technology enable customers' products to reach the ports faster and more cost effectively. These combined elements provide CN with the flexibility to work with customers to develop and grow their business.

Delivering just-in-time competitiveness

Hot coils, hot schedule

Customer: Alcan Aluminium Ltd.

Situation

Alcan Aluminium Ltd. delivers hot coils of aluminium from its Saguenay plant in Jonquière, Quebec, to Alcan's Terre Haute, Indiana, plant. Previously, CN moved Alcan shipments through a conventional gateway terminal in Buffalo, New York, where it was picked up by another rail carrier and taken to a warehouse operation in Indianapolis. From there it

was delivered by truck to Alcan Terre Haute.

Customer challenges

Improve Alcan transportation speed and consistency to support just-in-time inventory

CN's key strengths

Industry-leading technology

The key to disciplined growth is handling increased business with our existing infrastructure and fleet. Technology is a critical tool for achieving this. CN has developed industry-leading technology to become a scheduled railway, enabling us to maximize our assets and provide more responsive, predictable and reliable transportation services to our customers.

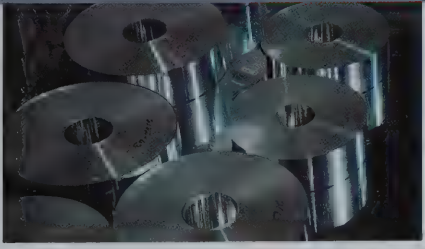
SRS, OTP and balanced scheduling – using technology to deliver on our customer commitments
Unpredictable transportation service costs customers money. As a scheduled railway, CN is providing more consistent, more dependable service that helps customers run their businesses more successfully. CN technology allows us to focus on individual customer shipments, rather than just our trains.

CN completed the first phase of developing our shipment management capability in 1996 by implementing the Service Reliability Strategy, or SRS. SRS is the new operating system that gives us the ability to schedule and monitor individual cars and containers against customer goals. When cars fall behind schedule, SRS allows us to identify it at the earliest possible time and take measures to correct it. We have reengineered our yard processes to enable us to accelerate the progress of cars behind schedule or in jeopardy of becoming behind schedule – and increase reliability for customers.

The second phase, called Operating to Plan (OTP), focuses on forecasting traffic volume to improve reliability, use our assets more efficiently and maximize responsiveness to our customers. OTP provides forecasting systems to link train progress, customer advance shipping data and information from shipping partners at other railways. We were initially able to forecast traffic volume 24 hours in advance. We then improved that to 48 hours. We can now forecast some traffic up to 72 hours in advance.

To support more accurate forecasting, CN developed a program called Customer Advanced Shipping Information (CASI).

Product: Hot aluminium coils



Deliver Alcan product within a critical temperature range. Alcan's product is delivered in the form of hot coils of aluminium. The coils are produced at the Saguenay plant in Jonquière and loaded, while still hot, on railcars. The coils must arrive within a specific temperature window to prevent condensation on the coils, which would compromise the finish and result in expensive spoilage.

management. Alcan, like most aluminium producers, must continually improve service to its customers and drive down costs to be competitive. This means that on-hand inventory must be kept at an absolute minimum, making a just-in-time strategy necessary. Transportation consistency and speed is absolutely critical to keeping Alcan competitive.

Route: Jonquière, Quebec, to Terre Haute, Indiana

CN solutions

A more effective logistics plan to improve Alcan's delivery speed and reliability. CN made use of its superior network by developing a service plan that involves direct CN haul to the Indiana Harbor Belt railroad in Chicago. We worked with existing third-party transshipping partners to offer this traffic to a new, state-of-the-art warehouse facility in

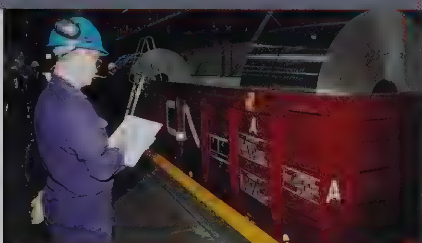
The CASI program is designed to help customers provide shipping information in advance and enable us to provide a more predictable supply of empty cars. Before, customers were over-ordering empty cars because of inconsistent availability. In a pilot program successfully completed in 1997, CN fundamentally changed the way it was providing empty cars to improve reliability. As a result, customers began to provide more accurate requests for empty cars and more solid information on car release. Most importantly, the program significantly improved customer satisfaction.

The first two phases of CN's shipment management initiative form a foundation for the third: balanced scheduling. With balanced scheduling, we are analyzing our own operations, cooperating with ports and working with customers to reduce the severity of swings between low- and high-demand periods. The goal is to smooth out the flow of traffic to and from customers, improving the overall quality of our service and efficiency of our system.

CN's new Customer Support Centre (CSC) in Winnipeg supports these initiatives by serving as the focus of day-to-day communications with customers. The centre handles requests for cars and service, provides shipment status information and addresses emergency service issues. With the successful implementation of the OTP initiative, the CSC's activities are increasingly effective in making sure customer goals are met.

New locomotive technology – improving reliability and efficiency

Another way CN is improving service to customers and utilization of assets is by acquiring new locomotives. As part of a long-term plan to improve the age of the fleet, CN took delivery of 75 new state-of-the-art locomotives in 1997. These direct-current, diesel-electric locomotives have contributed, along with our expanded, innovative "Power-by-the-Mile" maintenance agreements with the manufacturers, to improved fleet reliability. Performance, measured by failures



Hammond, Indiana. The third-party operators' expertise completed the logistics chain, handling traffic at the warehouse and delivering by truck to Alcan Terre Haute.

Specialized new CN equipment to handle increased volume and maintain Alcan's quality. CN commissioned the construction of new gondolas, increasing the existing fleet by 29 per cent. This equipment is specially insulated and covered to maintain the temperature needed to preserve product quality.

Customer results

Improved Alcan delivery reliability and speed. Through CN's improved routing and overall process control, Alcan realized significant improvements in speed and consistency of their shipments. Before CN took over direct haul, the average delivery took six

days, with 40 per cent of the loads taking longer. Now, delivery takes an average of less than five days, with only 10 per cent taking longer. This improvement of shipment time and reliability significantly reduces Alcan's costs and improves overall quality of the delivered product.

Increased shipment volume. Alcan's confidence in CN has allowed them to increase the volume of their shipments along our improved logistics chain.

per million miles, has continued to improve over the past three years. Fleet reliability improved by 15 per cent over 1996. Locomotive utilization reached 56.3 per cent, surpassing our goal for the year of 55 per cent. These new locomotives also enhance our competitiveness with better fuel efficiency and lower maintenance costs. With improved management capabilities afforded by SRS and OTP, we are able to match these more efficient locomotives to the shipments where they bring the most customer advantage.

Applied technology for improved safety

Safety is a top priority at CN, and one key to improvement is technology. CN uses sophisticated sensors to detect overheated bearings as trains pass along the main line. Impact detectors check railcar wheels for defects. Electronic inspection cars regularly scan the tracks for defects invisible to the naked eye. We also use technology in new ways to improve safety, such as increasing rail testing in the winter, when more rail failures occur.

Technology is an important tool for improving safety performance, but it is just that – a tool. A strong emphasis in 1997 was to make safety a core value at CN. Safety is good business, and CN people are the most powerful source for improvement.

Providing U.S. market access to international steamship lines

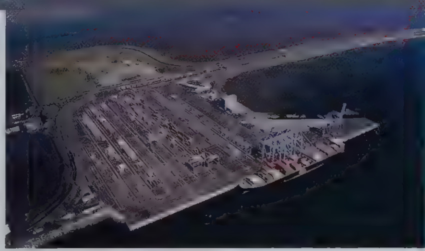
From Asia to North America's hub

Customer: International shippers

Typical volumes grew by 33 per cent from 1996 to 1997. In 1998, Alcan plans to further grow the volume by 21 per cent.

Situation

The shipping corridor from the Asia Pacific region to North America's west coast is the fastest growing in the world. Huge container vessels arrive daily at one of Vancouver's three major container terminals carrying cargo from China, Korea, Japan, Taiwan, Hong Kong and other industrial centres in Asia and the Pacific Rim. Major steamship lines depend on land transportation partners to take their customers' goods to final destinations inland with effective intermodal capabilities.



Customer challenges

Ensure access to port and inland transportation infrastructure that can meet changing needs. In the near future, steamship lines may be using vessels with nearly twice their current capacity. Five years from now, vessels could be three times as big. If port and rail facilities cannot accommodate increased volume, costly bottlenecks will result.

Maintain economical and reliable land transportation links to destinations in North America. To succeed in the intensely competitive international shipping business, steamship lines need dependable,

At Canadian National, our corporate culture is a key strength. Every CN employee is focused on excellence – running a safe, profitable transportation business that enables customers to succeed in trade.

We continue to build upon a culture that thrives on challenge and change. This is critical for success in a railway industry where rapid consolidation and increasing competitive pressures on our customers are the norms.

Our employees understand that, to deliver on our customer commitments and successfully grow our business, we must focus on more than operations. Our job isn't just to move trains. It's to deliver products for our customers. As a reflection of this company-wide change in emphasis from operations to service, CN consolidated its management structure, changing it from a regional to a system-wide operating approach. This enhances accessibility, communication and responsiveness for CN customers.

There has been another profound change in our culture: we have become an investor-owned company. Many of our employees are shareholders. CN employees understand that the company is judged by our financial performance. This supports a company-wide focus on creating and building shareholder value.

It also supports a company-wide focus on improving efficiency and reducing costs. With the bulk of personnel cuts complete, our focus has shifted to containing and, where possible, reducing the cost of materials and services. A major initiative is CN's supply chain management philosophy, which encourages long-term relationships with suppliers and focuses on total cost rather than unit cost. This approach reduced expenses by $35 million in 1997.

Creating a culture of safety

People are the most important factor in significantly improving safety performance. That's why CN is taking a behaviour-based approach, with programs aimed at

CN's key strengths

A performance-driven culture

Product: [illegible] in large intermodal containers

consistent and flexible service to convey their cargo inland. Consistency is as important as speed – widely varying, unpredictable transportation times undermine the shippers' customer relationships.

CN solutions

Highly flexible, sophisticated facilities at Deltaport and Chicago gateway. CN provides high-capacity intermodal service at terminals in Vancouver and Chicago, the land transportation hub of North America. These state-of-the-art facilities offer maximum ability to accommodate shippers' needs, now and in the future.

Direct intermodal access from Vancouver to United States markets through Chicago. CN, through its Vancouver-to-Chicago rail corridor, offers international shippers a flexible, customer-focused partner to get their cargo from terminal to terminal. CN uses sophisticated technology in all facets of the logistics chain to ensure quality service.

Depending on the customer's capability, CN is able to receive notice of service requirements electronically prior to arriving through Electronic Data Interchange (EDI). CN promotes and uses EDI technology to accelerate speed and accuracy of information exchange for shipping instructions, customs clearance and monitoring transit details as containers move through the system.

Route: Vancouver, British Columbia, to Chicago, Illinois

changing employees' attitudes. The effort, headed by a new vice-president, Risk Management, is managed by an 11-person System Steering Committee which includes the CN Safety Ombudsman. The group meets once a month, every other month in the field. Minutes from each meeting are sent to all health and safety committees across the CN system. In the field, the committee meets with the local health and safety committee in the morning and, in the afternoon, observes operations out on the network.

One specific program addressed fatigue created by railroading's traditionally erratic work schedules. The Alertness Assurance program looked at the human body's natural rhythms of sleep and alertness to develop and test a set of fatigue countermeasures. The goal was to enhance alertness among train crews without adversely affecting train operations. The result was a series of policies designed to reduce fatigue, such as changes in work scheduling, improved rest facilities, lifestyle presentations to families and more.

CN is also partnering with customers to run a safer railway. We are the first transportation company in Canada to join an initiative sponsored by the Canadian Chemical Producers' Association (CCPA) called Responsible Care™. Responsible Care™ was created by the CCPA to improve the chemical industry's management of chemicals and its safety, health and environmental performance. Responsible Care™ complements CN initiatives already in place for the transportation of dangerous goods and protection of the environment.

Once in Vancouver, shipping containers are lifted off the ship by huge shoreside cranes and transferred directly across the terminal to waiting CN railcars. When fully loaded, the train immediately departs Vancouver on its journey to Chicago. Over the next four days, the train will stop only briefly for crew changes and routine safety processes.

The train arrives at CN's Gateway Intermodal Terminal in Harvey, Illinois, just south of Chicago. High-speed side-lift and overhead cranes work in concert with yard tractors, efficiently transferring containers to trucks or other rail carriers for transport to their final destinations.

Customer results

Terminals that can grow as shippers grow. New terminals in Vancouver and Harvey offer sophisticated, high-capacity container handling capabilities to help shippers compete. In Vancouver, the new Deltaport terminal doubles the port's capacity to one million containers per year. The Gateway terminal can handle 225,000 containers per year with capacity for 500,000 as needs grow.

CN today

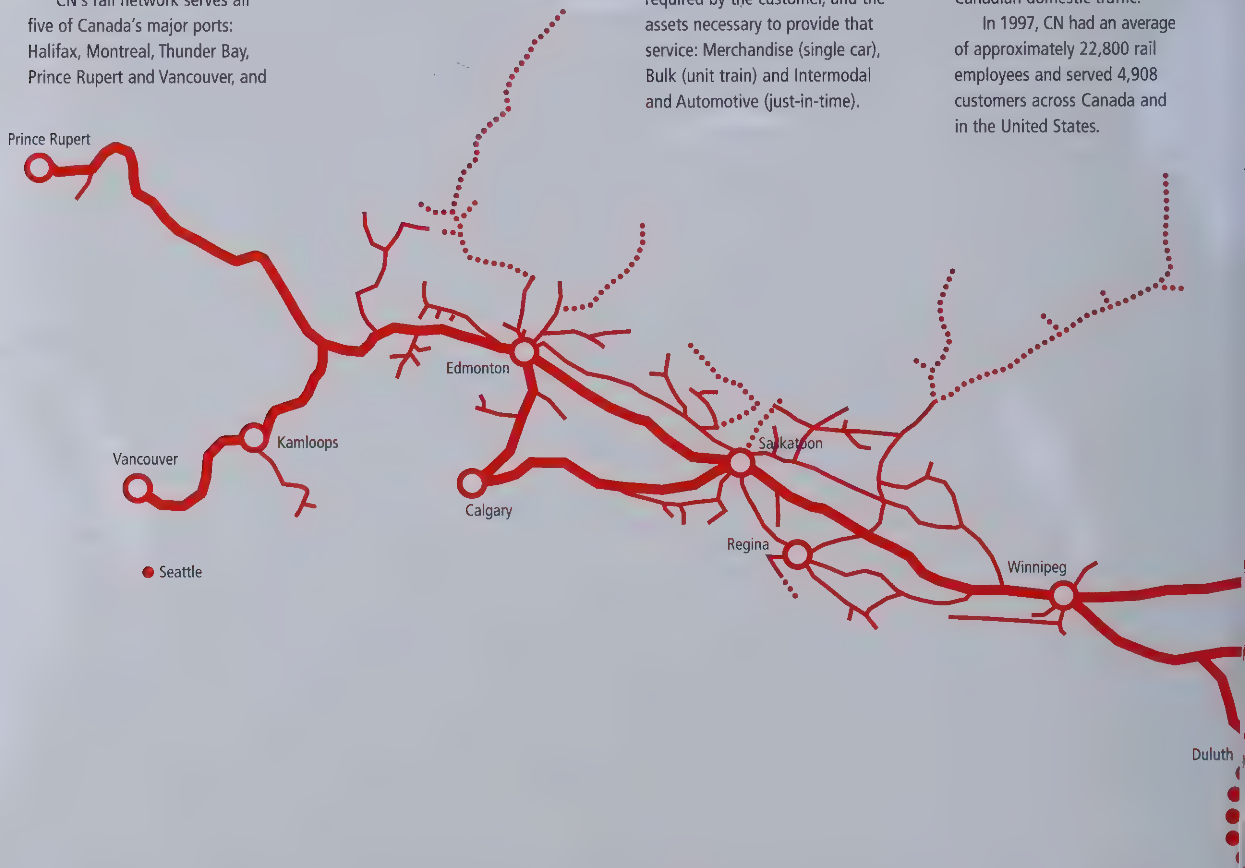
Canadian National Railway Company (CN) is Canada's largest railway system, with more than 14,500 route miles of track in Canada and approximately 750 route miles of track in the United States.

CN's rail network serves all five of Canada's major ports: Halifax, Montreal, Thunder Bay, Prince Rupert and Vancouver, and includes strategic connections to the United States through the Chicago gateway, Detroit and other major cities.

CN generates revenues from the movement of a diversified and balanced portfolio of industrial products; forest products; grain and grain products; coal, sulphur and fertilizers; intermodal; and automotive. In 1997, we consolidated management of our six business categories into three business groups based on type of service required by the customer, and the assets necessary to provide that service: Merchandise (single car), Bulk (unit train) and Intermodal and Automotive (just-in-time).

About 38 per cent of our revenues come from transborder and domestic U.S. traffic. Another 32 per cent of CN revenues derive primarily from import and export traffic. The remaining 30 per cent of revenues are derived from Canadian domestic traffic.

In 1997, CN had an average of approximately 22,800 rail employees and served 4,908 customers across Canada and in the United States.



Merchandise business unit

Industrial products

The industrial products business includes a wide range of commodities such as chemicals and plastics, petroleum and gas products, metals and construction materials. Most of these products are destined to customers via CN's eastern and western corridors to Chicago. Our access to northern Alberta's natural gas production centres and virtually all of Canada's largest plastics producers, and exclusive access to major aluminium smelters in Quebec and British Columbia, are key factors to CN's competitive advantage.

Forest products

CN's forest products business consists of four commodities: lumber, fibres, paper and panels. Most forest product traffic moves either via CN's main corridor from western Canada to Chicago, or from northeastern Canada to midwestern and eastern interchange points with major U.S. railroads. Most of the traffic is destined for the northern, midwestern and southeastern United States. In both eastern and western Canada, CN has superior access to the major fibre-producing regions of Canada, the world's largest exporter of forest products.

Bulk business unit

Grain and grain products

Canadian National's grain and grain products business mainly consists of three commodities, primarily grown or processed in western Canada: wheat, barley and canola. More than 65 per cent of traffic in this business segment moves from western Canada to terminals at Vancouver and Prince Rupert on the west coast, and Thunder Bay on Lake Superior, for overseas export. The balance of traffic moves to a wide variety of North American destinations.

Coal, sulphur, and fertilizers

The majority of traffic in this segment originates in western Canada and is exported to the United States, or overseas from ports in British Columbia. Coal is used for steel production in Japan and other Asian nations, as well as for utilities in North America. Canadian sulphur, potash and phosphate rock are exported to a large number of nations for the production of fertilizers. CN's network has the lowest grades over the Rocky Mountains and superior access to west coast ports, which affords customers low-cost, efficient rail transportation of raw materials critical to their competitiveness.

1997 data

Freight revenues	(In millions)
Industrial products	$893
Forest products	824
Grain and grain products	692
Coal, sulphur, and fertilizers	635
Intermodal	776
Automotive	435

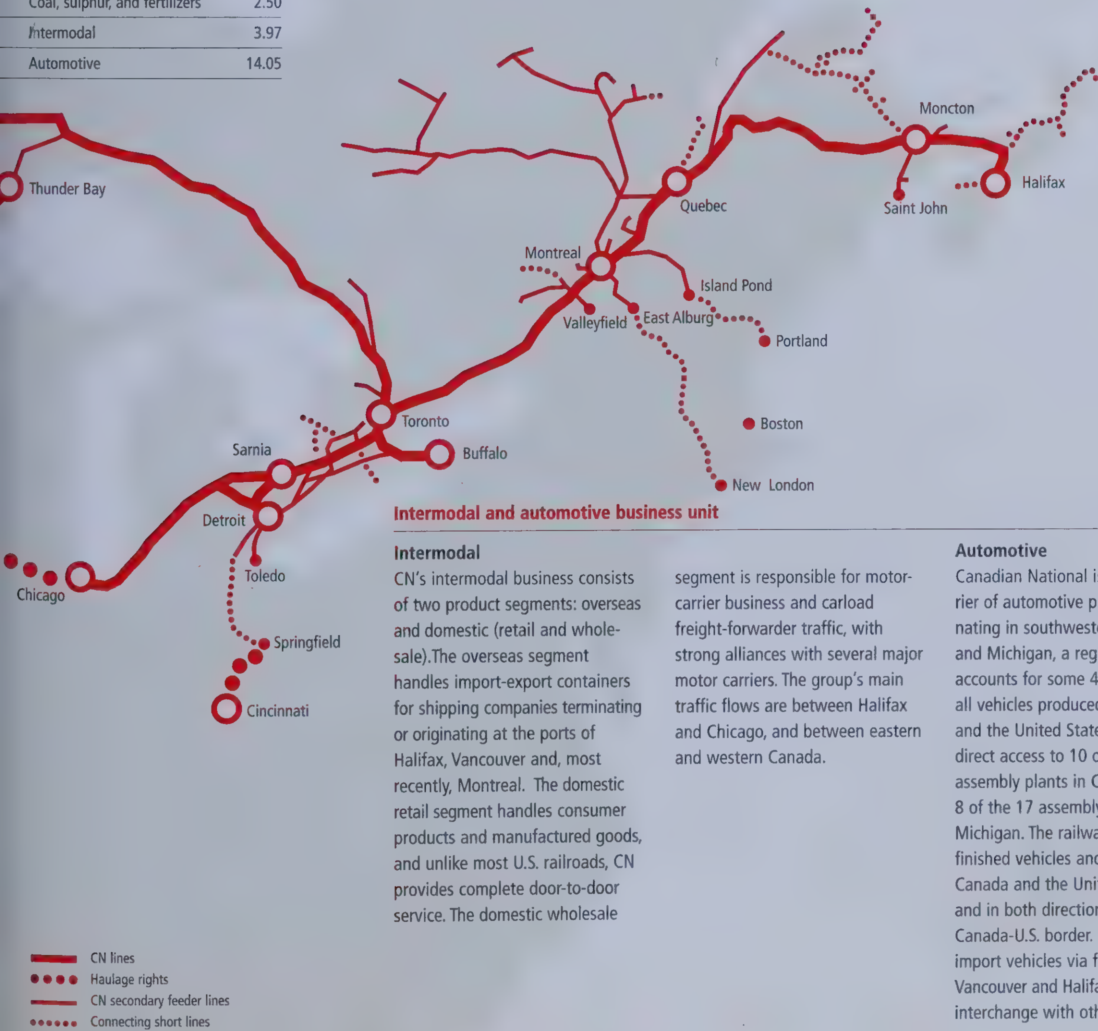
Revenue ton miles	(In millions)
Industrial products	23,993
Forest products	22,784
Grain and grain products	24,676
Coal, sulphur, and fertilizers	25,445
Intermodal	19,541
Automotive	3,095

Freight revenues per revenue ton mile	(In cents)
Industrial products	3.72
Forest products	3.62
Grain and grain products	2.80
Coal, sulphur, and fertilizers	2.50
Intermodal	3.97
Automotive	14.05

1997 percentage data

Freight revenues

Industrial products	21%
Forest products	20%
Grain and grain products	16%
Coal, sulphur, and fertilizers	15%
Intermodal	18%
Automotive	10%



Intermodal and automotive business unit

Intermodal

CN's intermodal business consists of two product segments: overseas and domestic (retail and wholesale).The overseas segment handles import-export containers for shipping companies terminating or originating at the ports of Halifax, Vancouver and, most recently, Montreal. The domestic retail segment handles consumer products and manufactured goods, and unlike most U.S. railroads, CN provides complete door-to-door service. The domestic wholesale segment is responsible for motor-carrier business and carload freight-forwarder traffic, with strong alliances with several major motor carriers. The group's main traffic flows are between Halifax and Chicago, and between eastern and western Canada.

Automotive

Canadian National is a leading carrier of automotive products originating in southwestern Ontario and Michigan, a region that accounts for some 40 per cent of all vehicles produced in Canada and the United States. CN has direct access to 10 of the 14 auto assembly plants in Canada and 8 of the 17 assembly plants in Michigan. The railway transports finished vehicles and parts within Canada and the United States, and in both directions across the Canada-U.S. border. CN also moves import vehicles via facilities in Vancouver and Halifax, and through interchange with other railways.

"I know the pressures that CN employees work under, and I believe you can't thank employees often enough for their excellent work and dedication. These awards recognize employee excellence, creativity and initiative."
– Paul M. Tellier

Category 1: New business opportunities

Ed Bruzzese, Tim Cowieson, Monica Balko-Blaney, Larry Gueran, Larry Stevenson, Doug Hayden-Luck, Owen Yathon and Ken Neyedly

The teamwork of Marketing, Transportation, Operations, and Customer Support Centre (CSC) employees led to a five-year contract to move potash from Occidental Chemical Corporation's Saskatchewan mines to its plants in Evans City and Mobile, Alabama, and Reybold, Delaware. The team was so successful, OxyChem named CN Carrier Of The Year for 1996, the first Canadian railroad to receive such an honour.

Category 2: Safety

Dave Gunn, Floyd Morrissey, John Holmes, Brian Lockhart, Charles Boyd, Patrick Humphries, Pat Adams and John Fraser

This employee team defined a new safety standard for CN's yard in Saint John, New Brunswick. They developed a five-point plan that dramatically reduced accidental derailments in the yard, thereby improving safety standards for employees and reducing potential delays to customers' shipments.

Category 3: Exceptional service

John Smith, John Boulding, Jim Macready, Corky Gaboriau, Al Dzuba, Ron Lemaire, Murray Samulak, Zeljko Kavaz, Dennis Stewart and John Fediuk

To meet customers' delivery needs, these employees from Saskatoon and Melville, Saskatchewan, repaired almost 350 locomotives each month during the winter of 1996-97, one of the worst on the Canadian Prairies.

Category 4: Operational breakthrough

Jacques Beaurivage and Paul-Aimé Landry

This team from CN's Joffre Yard in Quebec City developed a piece of equipment that reduces the time required to change tank car wheels on CN's Ultratrain from three hours to just 20 minutes. The Ultratrain delivers gasoline from Ultramar's refinery outside of Quebec City to Montreal about 20 times per week. It is made up of many tank cars permanently linked together by an enormous fuel transfer line which makes unloading gasoline easy and preventive maintenance a challenge.

Category 5: People management

Johanne Battista

Johanne Battista's leadership skills and sincere concern for the well-being of the employees she manages has earned her the admiration of the Supply Initiatives Team, part of CN's Supply Management department.

Category 6: Cost effectiveness

Jean-François Guy, A. Garry Marcus, Frank Taylor, Stan Nordal and Victor Santiago

The goal of this special team – made up of Engineering, Finance and Line Operations employees – was to optimize the operation of the Work Equipment department and reduce the overall costs of its operations. The team not only saved CN $11.5 million, but also improved efficiency at the same time.

Category 7: Quality improvement

Teresa Edwards, Bob Spahn, Bob Leonard, Steven Redmond, John Leonard, Joe Bekavac, Doug MacDonald, Ty Gibson and Brian Hamilton

By tenaciously following the classic principles of process improvement, this team greatly improved the quality of customer service at CN's yard in Sarnia, Ontario. The plan included strategies to deal with seasonal staffing issues, operational and management processes, employee training, advanced planning and improvements in efficiency. They saved CN more than $340,000.

Category 8: Environment

Bob James

As the facility maintenance supervisor in Moncton, New Brunswick, Bob James assists with CN's environment plan and emergency response there. But it's his personal concern for the environment that makes Bob James special. He has shared his passion for the environment with his staff, and through his example, they too have become environmental leaders.

Special Mention: Bravery

Dan Mould and Tim Kangas
These two car mechanics from CN's Talbotville, Ontario, facility rescued two car accident victims when a car in front of them lost control on wet pavement, was hit by another vehicle, and then burst into flames.

Ruggero Guadagnin
While his train was stopped at a red signal light in the town of Brockville, Ontario, conductor Ruggero Guadagnin thwarted a potential explosion by removing wooden pallets and propane tanks from the path of a fire that was quickly spreading.

Gordon East, Dennis Kasprowicz, Allen Bashutski and Russell Michayluk
These four employees from Melville, Saskatchewan, rescued two women and a sleeping man who were unaware that their house had caught on fire.

Ken Lomond
CN Police Special Agent Ken Lomond from Saskatoon, Saskatchewan, prevented extensive fire damage, the possible derailment of a train and an explosive fire at a co-op gasoline and diesel storage facility.

Contents

Canadian National Railway Company

18 Financial highlights
19 Selected railway statistics
20 Progress on various strategic initiatives
22 Management's discussion and analysis
35 Management report
35 Auditors' report
36 Consolidated statement of income
37 Consolidated balance sheet
38 Consolidated statement of shareholders' equity
39 Consolidated statement of changes in financial position
40 Notes to consolidated financial statements

The CN Pension Plan and the CN 1935 Pension Plan

56 General review
57 Trustee's report
57 Actuary's report
58 Auditor's report
59 Consolidated statement of net assets at market value
60 Consolidated statement of changes in net assets at market value
61 Notes to consolidated financial statements

FINANCIAL HIGHLIGHTS

1997 overview – Another record year for Canadian National

The year 1997 marked a new phase in CN's evolution as a shareholder-owned company. Revenues, carloads and on-time performance all reached record levels in 1997 as a result of the Company's focus on a strategy for profitable revenue growth, improved utilization of assets, delivering on customer commitments, and continued cost containment. This strategy enabled CN to attain the following:

- **Increase income from continuing operations (excluding special charges) 42% to $421 million;**
- **Increase fully diluted earnings per share 29% to $4.63;**
- **Decrease operating ratio (excluding special charges) 3.2 points to 81.5%;**
- **Increase revenues 9% – attributable to all business groups – leading to a record total revenue of $4.4 billion;**
- **Increase revenue ton miles 11% – leading to a record of 119.5 billion;**
- **Hold costs to an increase of 5%;**
- **Increase cash flow before financing activities from $58 million to $160 million;**
- **Improve return on assets from 6.2% to 7.4%; and**
- **Best fourth-quarter service performance in history – key Intermodal and Merchandise trains 91% and 79% on-time performance, respectively.**

Proposed Canadian National – Illinois Central merger

CN and Illinois Central (IC) entered into a merger agreement pursuant to which the Company would acquire all of the common stock of IC for a combination of cash and stock valued at U.S. $39.00 per IC share. IC has approximately 61.4 million shares outstanding giving the transaction a total equity value of approximately U.S. $2.4 billion. The stock of IC will be placed in trust until the Company's control application is approved by the Surface Transportation Board (STB). The combined strength of CN and IC would include:

- **A seamless North-South network from all major markets in Canada through Chicago and Detroit to the Gulf of Mexico, positioning CN along a rapidly growing trade corridor which had 1997 annual rail revenues of over $5 billion;**
- **Ability to capitalize on the liberalization of trade among Canada, United States and Mexico, which is growing annually at double-digit rates;**
- **A broader array of rail service options in key North-South traffic lanes;**
- **Expedited, more reliable and more efficient single line service that would free up assets, increase rail car availability and reduce switching between the two railways;**
- **Enhanced competition at all points served by the combined rail network including new port options for shippers;**
- **Improved opportunities for diverting traffic from highways between Southwest Ontario, the Midwest and beyond by improving CN's Intermodal network;**
- **Reduced reliance on truck-laden interstate highways; and**
- **Integration of the best safety practices of both companies throughout the Canadian and U.S. transportation systems.**

SELECTED RAILWAY STATISTICS

Year ended December 31	**1997**	1996	1995
Rail operations			
Freight revenues *($ millions)*	**4,255**	3,886	3,844
Gross ton miles *(billions)*	**228.4**	208.3	204.1
Revenue ton miles (RTM) *(millions)*	**119,534**	107,470	105,487
Route miles *(includes Canada and the U.S.)*	**15,292**	17,124	17,918
Operating expenses excluding special charges per RTM *(cents)*	**2.97**	3.15	3.33
Freight revenue per RTM *(cents)*	**3.56**	3.62	3.64
Carloads *(thousands)*	**2,547**	2,315	2,295
Freight revenue per carload *($)*	**1,671**	1,679	1,675
Diesel fuel consumed *(Canadian gallons in millions)*	**272**	259	256
Average fuel price *($/Canadian gallon)*	**1.23**	1.22	1.08
Revenue ton miles per Canadian gallon of fuel consumed	**439**	415	412
Locomotive bad order ratio *(%)*	**10.1**	11.2	10.0
Freight car bad order ratio *(%)*	**3.7**	4.0	5.2
Productivity			
Operating ratio excluding special charges *(%)*	**81.5**	84.7	88.9
Freight revenue per route mile *($ thousands)*	**278**	227	215
Revenue ton miles per route mile *(thousands)*	**7,817**	6,276	5,887
Freight revenue per average number of employees *($ thousands)*	**187**	161	143
Revenue ton miles per average number of employees *(thousands)*	**5,243**	4,466	3,914
Employees			
Number at end of year	**21,081**	21,589	23,999
Average number during year	**22,800**	24,064	26,951
Labour and fringe benefits per RTM *(cents)*	**1.20**	1.29	1.40
Injury frequency rate per 200,000 person hours	**1.6**	2.1	2.5
Accident rate per million train miles	**2.2**	3.0	2.6
Financial			
Debt to total capitalization ratio *(% at end of year)*	**33.0**	33.1	41.0
Return on assets at end of year *(%)*	**7.4**	6.2*	5.4*

Certain of the 1996 and 1995 comparative figures have been reclassified in order to be consistent with 1997 presentation.
**Based on the adjusted results.*

PROGRESS ON VARIOUS STRATEGIC INITIATIVES

- **Launch of "New England Clipper Service"**
  New international intermodal service between the major ocean port of Halifax, Nova Scotia and the Boston and New England markets;

- **Inauguration of Gateway Intermodal Terminal at Harvey, Illinois**
  The terminal complements other elements of the Company's strategy to increase its U.S. presence. Those other strategy components include the St. Clair Tunnel, which reduces transit times from the U.S. industrial heartland to ocean ports, as well as alliances with some of North America's major rail and road carriers;

- **Opening of new Deltaport container terminal**
  CN is a partner in Deltaport which is one of the most advanced terminals of its kind in the world and effectively doubles Vancouver's container-handling capacity;

- **New Chicago CargoFlo break-bulk terminal**
  The 35-acre facility occupies the former CN Intermodal terminal eight miles from downtown Chicago offering easy access to Interstate Highway 55. Fully paved, fenced and illuminated, the eight-track terminal provides loading and unloading capacity for 120 railcars. The terminal is operated by Chemical Leaman Tank Lines Inc., a large transporter of plastics and petrochemicals;

- **Network Rationalization Program**
  The Company's strategic goal is to transform itself into a long-haul, high-density railroad fed by low-cost, growth-oriented short lines. As part of this objective, 1,500 route miles representing 9% of the total number of route miles at the beginning of the year, were rationalized from the network, including the following transactions:

  Northern Alberta lines – 640 miles of track running from Smith, Alberta to Hay River, North West Territories as well as a branch line west of Peace River, Alberta to Hines Creek, Alberta, were sold to RaiLink, Ltd. The lines primarily serve the agricultural, forest products and northern re-supply industries;

  Intercolonial line – 301 miles of track between Moncton, New Brunswick and Mont-Joli, Quebec, serving mainly shippers in the mining and pulp and paper industries, were sold to the Quebec Railway Corporation;

  Northwest Saskatchewan lines – 279 miles of track in northwestern Saskatchewan, serving mainly the agricultural and forest products industries, were sold to OmniTRAX;

  Hamilton and Hagersville lines – 35 miles of track linking Brantford, Ontario and Nanticoke on Lake Erie, and 4 miles of track serving Hamilton's north-end industrial area were leased to RaiLink, Ltd;

PROGRESS ON VARIOUS STRATEGIC INITIATIVES

- **Significant joint marketing and operating agreement with CSX Corporation**
  Permitting the two railroads to quote through rates for new business moving between certain points on each other's networks, setting up new arrangements at the important border crossing at Buffalo, N.Y. and letting CSX Intermodal use some CN lines in Chicago. It is anticipated that the new deal will maintain the competitiveness of CN traffic entering the U.S. northeast, improve CN's ability to recoup marketshare from trucks and build new Canada–U.S. traffic for both railways. In the event that U.S. regulators approve the acquisition and division of Conrail proposed by CSX and Norfolk Southern, CSX will become CN's main interchange partner for traffic to and from the U.S. northeast;

- **Selected by three of the world's largest container shippers to handle new business at the Port of Montreal**
  The container shippers will use CN to handle their new weekly service between Northern Europe and the Port of Montreal;

- **Customer-driven winter operations plan unveiled**
  Comprehensive, customer-driven winter operations plan that will help to maintain service commitments throughout the winter months; and

- **New locomotives acquired**
  The Company completed another phase in the locomotive upgrade program aimed at improving customer service. Since the beginning of 1996, the Company has added 180 new high-horsepower locomotives to the mainline fleet. The locomotives feature the most modern hauling technology, including microprocessor control systems and the latest in cab design, to provide train crews with an improved working environment.

Management's discussion and analysis relates to the financial condition and results of operations of Canadian National Railway Company ("CN" or "the Company"). CN and its wholly-owned U.S. subsidiary, Grand Trunk Corporation, operate a private sector freight railroad. CN's common shares are listed on the Toronto, New York and Montreal stock exchanges. All financial information reflected herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles ("GAAP") which conform, in all material respects, with those generally accepted in the United States except as discussed in Note 20 to the Consolidated Financial Statements.

In the fourth quarter of 1997, the Company adopted new accounting recommendations from the Canadian Institute of Chartered Accountants related to the accounting for income taxes. These recommendations require retroactive application and restatement of comparative figures. As such, the Company has restated the 1996 comparative figures to comply with these recommendations. The effect of this change in accounting for income taxes was to record an income tax recovery in 1996 in the amount of $708 million, for tax benefits not previously recognized, thereby increasing net income for 1996 to $850 million. There was no effect on the reported net loss of $1,085 million for 1995.

To facilitate a year-over-year comparison, net income for 1996 and 1995, in the following table, has been adjusted to exclude the 1996 and 1995 special charges of $381 million (for workforce reductions and costs to redeem, repurchase or defease long-term debt) and $1,453 million (for an asset impairment write-down, costs to redeem, repurchase or defease long-term debt, environmental costs, legal costs and certain other matters) as well as the 1996 one-time $708 million income tax recovery, and have been adjusted to apply income tax expense to the income from continuing operations. As a result, adjusted consolidated net income for 1996 and 1995 amounted to $310 million and $201 million, respectively.

In millions, except per share data	**1997**	1996	1995
Adjusted net income	**$ 403**	$ 310	$ 201
Tax effect on adjusted income from continuing operations	–	213	167
Subtotal	**403**	523	368
Special charges	–	(381)	(1,453)
One-time recovery of future income taxes	–	708	–
Net income (loss), as reported	**$ 403**	$ 850	$(1,085)
Adjusted earnings per share	**$4.74**	$ 3.65	$ 2.50
Tax effect on adjusted income from continuing operations	–	2.51	2.08
Special charges	–	(4.49)	(18.07)
One-time recovery of future income taxes	–	8.34	–
Earnings (loss) per share, as reported	**$4.74**	$10.01	$(13.49)

Financial results

1997 compared to 1996

The Company recorded a consolidated net income of $403 million ($4.74 per share) for the year ended December 31, 1997, compared to consolidated net income of $850 million in 1996 ($10.01 per share) and adjusted consolidated net income of $310 million ($3.65 per share) in 1996.

Operating income was $807 million for the year ended December 31, 1997 compared to $610 million, excluding special charges, in 1996, an increase of $197 million or 32%. There was a $357 million, or 9%, increase in revenues and a $160 million, or 5%, increase in operating expenses (excluding special charges). The improved financial performance was largely the result of the Company's focus on profitable revenue growth, improved utilization of assets, and cost containment. The operating ratio (excluding special charges) decreased from 84.7% to 81.5%, a 3.2-point betterment.

Revenues

Revenues for the year ended December 31, 1997 totalled $4,352 million, an increase of $357 million or 9% from the comparable 1996 level. The increase was attributable to all business groups with Grain and grain products at 23%, Intermodal at 15% and Automotive at 12% leading the way. Revenue ton miles increased by a corresponding 11%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year ended December 31	1997	1996	1997	1996	1997	1996
	Revenues		Revenue ton miles		Freight revenues per revenue ton mile	
	In millions				*In cents*	
Industrial products	**$ 893**	$ 851	**23,993**	22,551	**3.72**	3.77
Forest products	**824**	787	**22,784**	21,297	**3.62**	3.70
Grain and grain products	**692**	564	**24,676**	20,755	**2.80**	2.72
Coal, sulphur, and fertilizers	**635**	618	**25,445**	23,730	**2.50**	2.60
Intermodal	**776**	677	**19,541**	16,507	**3.97**	4.10
Automotive	**435**	389	**3,095**	2,630	**14.05**	14.79
Other items[1]	**97**	109	**–**	–	**–**	–
Total	**$4,352**	$3,995	**119,534**	107,470	**3.56**	3.62

(1) Principally non-freight revenues derived from third parties.

Industrial products – Revenues increased by 5% and volumes increased by 6%

The 1997 growth was mainly due to volume increases in the metals and petroleum products segments. Growth in the metals segment reflects market share gains, strong U.S. market demand for aluminium, and increased pipe movements to western Canada for pipeline construction and municipal development. New spot petroleum coke export moves from northern Alberta, as well as strong plastics demand, contributed to growth in the petroleum segment. Moderate gains were made in the industrial chemical and petrochemical segments. The decline in yield of 1% resulted from traffic mix changes and the effect of the Ultratrain operation.

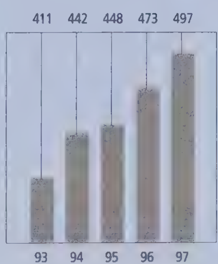
Forest products – Revenues increased by 5% and volumes increased by 7%

The improvement was due to increases in all forest products segments. Lumber traffic grew significantly due to a stronger U.S. housing market and successful market share gains. Growth in panels reflected the impact of various new oriented strand board mills which began production in 1996/1997. Improved market conditions and market share gains in newsprint relative to trucking contributed to the strength in the pulp and paper segment. The reduction in revenue per revenue ton mile resulted from increases in longer haul traffic.

Industrial products

Percentage of revenues

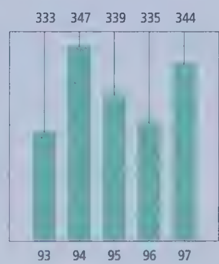
Carloads In thousands



Forest products

Percentage of revenues

Carloads In thousands



Grain and grain products – Revenues increased by 23% and volumes increased by 19%

The improvement is due to the 1996/1997 bumper grain crop compared to the previous year, continued strength in third and fourth quarter grain sales, and the regulated rate increases of 7.1% and 2% effective August 1996 and 1997, respectively. Revenue per revenue ton mile increased by 3%, primarily due to the rate increases, although these gains were partially offset by increases in longer haul traffic and increased haulage fees as a result of the Company's network rationalization program.

Grain and grain products

Percentage of revenues

Wheat	55%
Oilseeds	17%
Feed grains	17%
Other grains	11%

Carloads In thousands

Coal, sulphur, and fertilizers – Revenues increased by 3% and volumes increased by 7%

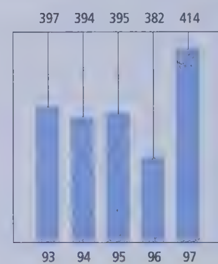
The increase reflects growth in potash, coal, and fertilizers segments. Growth in potash revenues were primarily a result of strong demand conditions both in U.S. and offshore markets. Increases in coal revenues reflect significant gains in domestic coal movements and limited growth in coal export traffic. The decline in yield of 4% was driven by changes in traffic mix in potash and coal.

Coal, sulphur, and fertilizers

Percentage of revenues

Coal	51%
Potash	23%
Fertilizers	15%
Sulphur	11%

Carloads In thousands



Intermodal – Revenues increased by 15% and volumes increased by 18%

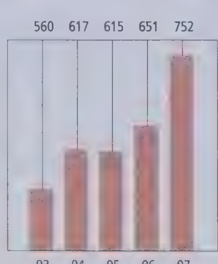
The increase reflects an improvement in the Company's market position as well as a strong economy generating healthy growth in domestic and, in particular, overseas market segments. The Company was able to capitalize on this growth partly as a result of on-time performance and service reliability improvements. Contributing to the yield decrease of 3% was the shift to longer haul traffic, particularly in overseas markets, and increased cartage charges.

Intermodal

Percentage of revenues

Domestic	64%
Overseas	36%

Carloads In thousands



Automotive – Revenues increased by 12% and volumes increased by 18%

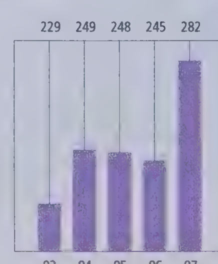
The strength in the Automotive business unit was due, in part, to double-digit growth in Canadian motor vehicle sales and moderate gains in U.S. sales. New contracts were signed for finished vehicles destined for the U.S. and parts traffic inbound to Ontario. The drop in revenue per revenue ton mile of 5% is attributable to a change in traffic mix.

Automotive

Percentage of revenues

Finished vehicles	78%
Vehicle parts	21%
Agricultural imports and miscellaneous	1%

Carloads In thousands



Operating expenses

Total operating expenses amounted to $3,545 million in 1997 as compared to $3,766 million, including special charges, in 1996. Excluding special charges of $381 million in 1996, operating expenses increased by $160 million or 5% from the 1996 period while revenue ton miles increased by 11%.

Dollars in millions — *Year ended December 31*	**1997**		1996	
	Amount	**% of revenue**	Amount	% of revenue
Labour and fringe benefits	**$1,431**	**32.9%**	$1,381	34.6%
Material	**316**	**7.3%**	297	7.4%
Fuel	**335**	**7.7%**	314	7.9%
Depreciation and amortization	**200**	**4.6%**	194	4.8%
Operating taxes	**186**	**4.3%**	171	4.3%
Equipment rental	**219**	**5.0%**	216	5.4%
Net car hire	**116**	**2.7%**	108	2.7%
Purchased services	**363**	**8.3%**	348	8.7%
Casualty and insurance	**103**	**2.4%**	85	2.1%
Other	**276**	**6.3%**	271	6.8%
	3,545	**81.5%**	3,385	84.7%
Special charges	**–**		381	
Total operating expenses	**$3,545**		$3,766	

Labour and fringe benefits: In spite of major volume increases in 1997 and severe winter weather conditions in the first quarter, these costs increased by only 4% or $50 million. This was largely due to the Company's downsizing initiatives, as average employment declined by 5%. Labour productivity, as measured by revenue ton miles per average number of employees, improved by 17% to 5.2 million.

Material: Costs of material consumed during 1997 were 6% or $19 million higher than in 1996 due to severe winter conditions in early 1997 and to costs incurred under the Winter Readiness Program in the latter part of the year. These costs were partially mitigated by the Company's continued aggressive sourcing initiatives and efficiencies arising from shop consolidation.

Fuel: The combined effect of price and traffic volume increases more than offset fuel efficiency savings, leaving a net increase in fuel costs of $21 million or 7% compared to 1996.

Depreciation and amortization: Acquisition of high-productivity locomotives in late 1996 and in 1997, under the locomotive upgrade program, was the main factor behind the increase of $6 million or 3%.

Operating taxes: Increased provincial sales taxes, due to a one-time recovery in the third quarter of 1996, as well as increases in municipal and fuel taxes accounted for the $15 million or 9% increase in operating taxes in 1997.

Equipment rental: Such costs increased by $3 million or 1% compared with 1996 due mainly to additional short-term leases required as a result of increased volumes offset by the acquisition of cars previously under operating leases.

Net car hire: Car hire costs increased by $8 million or 7% from 1996. The increase was due mainly to additional per diem car mileage payments as a result of increased traffic volumes mainly in Intermodal.

Purchased services: Costs of purchased services increased by $15 million or 4% from the 1996 level, due mainly to increased expenditures for professional services and contracted repairs.

Casualty and insurance: Costs increased by $18 million or 21% due mainly to increased provisions for legal claims related to injuries to persons and a 1996 $12 million recovery of insurance premiums associated with the liquidation of the Company's interest in an industry insurance association. This increase was partially mitigated by a decrease in the costs related to train accidents.

Other

Interest: Interest expense was $118 million in 1997 compared to $114 million in 1996, an increase of $4 million or 4%. This increase reflects the impact of the financing related to the locomotive upgrade program offset by the repurchase of some of the Company's outstanding long-term debt.

Other income: Other income for the year ended December 31, 1997 was $57 million compared to $27 million in 1996. The increase was due mainly to the second quarter 1997 $21 million gain realized on the sale of the Company's joint-venture interest in Halterm Limited and other property sales.

Income tax (expense) recovery from continuing operations: Income tax expense was $325 million in 1997 compared to a recovery of $694 million the preceding year. In the fourth quarter of 1997, the Company adopted new accounting pronouncements from the Canadian Institute of Chartered Accountants related to the accounting for income taxes. These recommendations required retroactive application and restatement of comparative figures. The effect of this change in accounting for income taxes was to record a recovery of future income taxes in 1996 in the amount of $708 million, $3 million of which was related to income (loss) from discontinued operations.

Discontinued operations: Consistent with the Company's plans to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary. The loss from discontinued operations (net of applicable income taxes) includes the current year loss as well as a provision for future losses from the discontinued operations, and amounted to $18 million for 1997. Discontinued operations (net of applicable income taxes) provided income of $14 million in 1996 due primarily to the gain on sale of CN France S.A.

1996 compared to 1995

The Company recorded a consolidated net income of $850 million ($10.01 per share), adjusted consolidated net income of $310 million ($3.65 per share) in the year ended December 31, 1996, compared with a consolidated net loss of $1,085 million ($13.49 per share), adjusted consolidated net income of $201 million ($2.50 per share) in 1995.

Including special charges, rail operations recorded operating income of $229 million in the year ended December 31, 1996 compared with an operating loss of $1,013 million in 1995. Excluding special charges, rail operations produced operating income of $610 million in 1996, an increase of $170 million or 39% from 1995. There was a $41 million gain in revenues and a $129 million reduction in operating expenses (excluding special charges). The improved financial performance was primarily the result of the Company's ongoing implementation of its cost reduction strategy. The operating ratio (excluding special charges) decreased from 88.9% to 84.7%.

Revenues

Revenues for the year ended December 31, 1996 totalled $3,995 million, an increase of $41 million or 1% from the comparable 1995 level. Revenue ton miles increased by 2%. The increased volume was attributable mainly to a 14% increase in Intermodal traffic and a 6% increase in Industrial products.

Year ended December 31	1996	1995	1996	1995	1996	1995
	Revenues		Revenue ton miles		Freight revenues per revenue ton mile	
	In millions				*In cents*	
Industrial products	$ 851	$ 838	22,551	21,328	3.77	3.93
Forest products	787	771	21,297	21,278	3.70	3.62
Grain and grain products	564	600	20,755	22,861	2.72	2.62
Coal, sulphur, and fertilizers	618	601	23,730	23,012	2.60	2.61
Intermodal	677	635	16,507	14,537	4.10	4.37
Automotive	389	399	2,630	2,471	14.79	16.15
Other items(1)	109	110	–	–	–	–
Total	$3,995	$3,954	107,470	105,487	3.62	3.64

(1) Principally non-freight revenues derived from third parties.

Industrial products – Revenues increased by 2% and volumes increased by 6%

Petroleum products led the way, with increased demand for liquefied petroleum gas, strong performance in fuel oils due to cold weather early in the year and the Ultratrain operation (a very high volume short-haul unit train for petroleum products) which began in August 1996. Gains were also registered in plastics and industrial chemicals, which were fueled by solid market demand and improved market share in specific chemical markets. The decline in yield resulted from traffic mix changes and the effect of the Ultratrain.

Forest products – Revenues increased by 2% and volumes remained basically flat

Growth in lumber and panel traffic was driven by stronger housing markets in Canada and the U.S., as well as the start-up or expansion of six oriented strand board mills on CN lines. These gains were offset by a decrease in the fibre segment, caused primarily by low demand for woodchips due to plant shutdowns in the pulp and paper sector. Newsprint was also down in 1996, in line with weak market demand in the U.S. Changes in traffic mix, and pricing structure are responsible for the 2% increase in yield.

Grain and grain products – Revenues decreased by 6% and volumes dropped by 9%

During the first two quarters of 1996, grain shipments had been negatively impacted by a lower supply of grain in CN territory, severe winter conditions and slow producer deliveries. This weakness was reversed late in the third quarter due to a large western crop and culminated in a strong fourth quarter gain. Revenues per revenue ton mile increased 4%, primarily due to a rate increase of 7% in August 1996 on regulated export grain, which accounts for about two-thirds of grain tonnage transported. CN is continuing to encourage new or upgraded long-term elevators and processing facilities on its lines. In 1996, CN customers announced the construction of 11 new high through-put elevators. In addition, the largest canola crushing facility in Canada opened on CN lines in June 1996.

Coal, sulphur, and fertilizers – Revenues and volumes increased by 3%

Revenues and volumes increases were led by: increased fertilizer movements to U.S. markets; new potash traffic, in spite of an overall decline in Canadian potash exports; and increased share of the Canadian domestic coal market. These gains were partly offset by drops in sulphur exports to the U.S. and in export coal, due to production problems at three mines.

Intermodal – Revenues increased by 7% and volumes increased by 14%

All segments were up, led by overseas with an 18% increase in revenues. This growth was driven by strong Canadian trade and significant increases in traffic between Halifax and Chicago and from Vancouver to Central Canada. Domestic growth was driven by overall economic conditions and especially by increased use of CN's improved intermodal service by retail customers and truckers across Canada. Rerouting of transcontinental traffic away from the Ottawa Valley route for operational efficiency reasons caused an increase in the average length of haul. Also contributing to the decreased yield was a change in mix and a shift of business from retail to wholesale.

Automotive – Revenues decreased by 3% and volumes increased by 6%

The volume growth reflects improving motor vehicle markets in the U.S. and Canada and an increase in the average length of haul. This growth was achieved in spite of the CAW strike at GM which lasted 21 days in October 1996, mostly impacting finished vehicle traffic from the Oshawa plants, and the UAW strike which lasted 17 days in March 1996, affecting parts traffic and finished vehicle movements from Oshawa, Ontario, Lansing and Pontiac, Michigan. The drop in revenues per revenue ton mile is attributable to the increase in the average length of haul and a change in mix.

Operating expenses

Total operating expenses including special charges amounted to $3,766 million in 1996 as compared to $4,967 million in 1995. Excluding special charges of $381 million in 1996 and $1,453 million in 1995, operating expenses decreased by $129 million or 4% from the 1995 period while traffic levels increased by 2%.

Dollars in millions — *Year ended December 31*	1996		1995	
	Amount	% of revenue	Amount	% of revenue
Labour and fringe benefits	$1,381	34.6%	$1,477	37.4%
Material	297	7.4%	318	8.0%
Fuel	314	7.9%	277	7.0%
Depreciation and amortization	194	4.8%	231	5.8%
Operating taxes	171	4.3%	192	4.9%
Equipment rental	216	5.4%	194	4.9%
Net car hire	108	2.7%	117	3.0%
Purchased services	348	8.7%	354	9.0%
Casualty and insurance	85	2.1%	52	1.3%
Other	271	6.8%	302	7.6%
	3,385	84.7%	3,514	88.9%
Special charges	381		1,453	
Total operating expenses	$3,766		$4,967	

MANAGEMENT'S DISCUSSION AND ANALYSIS

Labour and fringe benefits: These costs decreased by $96 million or 6%, as the Company experienced significant labour savings from its workforce reduction program. Average employment declined by 11% from 1995. A decrease in pension expense, as a result of improvement in the return on the Company's pension plan assets, also contributed to lower labour and fringe benefit costs. These reductions were partly offset by increased wage rates under collective labour agreements. As measured by revenue ton miles per employee, the Company's overall productivity improved by 14% to 4.47 million, resulting in the nearly 3-point drop in labour and fringe benefit costs expressed as a percentage of revenues.

Material: Costs of material consumed during 1996 were 7% lower than in 1995. The decrease was achieved as a result of reduced shopwork combined with improved equipment maintenance procedures and more efficient purchasing practices.

Fuel: Increases of 12% in fuel prices and 2% in traffic volumes, partly offset through improved efficiency, caused an increase in fuel expense of $37 million or 13% compared to 1995.

Depreciation and amortization: This expense decreased by $37 million or 16%. The reduced asset base resulting from the $1,300 million write-down of rail operating assets in the east in June 1995 reduced depreciation by $60 million for the full year compared to $30 million in 1995. The sale and leaseback of the Company's vehicle fleet in the fourth quarter of 1995 was a further factor in the decrease.

Operating taxes: Reductions in provincial sales taxes and municipal taxes due to exemptions from certain school taxes on bridges and right of way combined with a refund of sales taxes relating to rolling stock, resulted in a $21 million or 11% decrease in operating taxes compared with 1995.

Equipment rental: Such costs increased by $22 million or 11% compared with 1995. Higher rentals due to the sale and leaseback of the Company's vehicle fleet were partly offset by reduced rentals for covered hopper cars leased for grain service.

Net car hire: Car hire costs decreased by $9 million or 8% from the 1995 level. The decrease was attributable mainly to fewer foreign cars on-line, fewer short-term operating leases and the Company's efforts to improve car cycles.

Purchased services: Costs of purchased services decreased by $6 million or 2% from the 1995 level, due mainly to lower advertising and reproduction costs offset by increased expenditures for outsourcing and professional services and contracted repairs.

Casualty and insurance: Costs increased by $33 million or 63% due to increased provisions for legal claims and train accidents and increased costs for personal injury claims, partly offset by a $12 million recovery of insurance premiums associated with the liquidation of the Company's interest in an industry insurance association.

Special charges: Special charges of $381 million in 1996 included $365 million related to workforce reductions while $16 million related to the Company's debt reduction program. The downsizing charge relates to a total of 2,250 reductions which began in the fourth quarter of 1996. Special charges of $1,453 million in 1995 included $1,300 million with respect to an asset impairment write-down of certain of the Company's railway assets.

Other

Interest: Interest expense was $114 million in 1996 compared to $198 million in 1995, a reduction of $84 million or 42%. This was a result of the repayment and defeasance of $1,046 million of long-term debt undertaken at the time of the Company's privatization.

Other income: Other income for the year ended December 31, 1996 was $27 million compared to $100 million in 1995. The reduction was due primarily to income in 1995 having included a gain of $39 million on the sale of the operating assets of Central Vermont Railway to a short-line operator and gains on sale of surplus rail properties.

Income tax (expense) recovery from continuing operations: Income tax recovery was $694 million in 1996 compared to an expense of $19 million the preceding year. In the fourth quarter of 1997, the Company adopted new accounting recommendations from the Canadian Institute of Chartered Accountants related to the accounting for income taxes. These recommendations required retroactive application and restatement of comparative figures. The effect of this change in accounting for income taxes was to record a recovery of future income taxes in 1996 in the amount of $708 million, $3 million of which was related to income (loss) from discontinued operations. There was no effect on the reported comparative figures for 1995.

Discontinued operations: During 1996, the Company sold its non-rail subsidiary CN France S.A. The financial effects of the disposal and operations of this formerly-owned business are included in Discontinued operations. Discontinued operations (net of applicable income taxes) provided income of $14 million compared to income of $7 million in 1995, due primarily to the gain of $14 million on the sale of CN France S.A. The 1996 and 1995 results from discontinued operations reflect the impact of exiting the Company's telecommunications business as discussed above.

Liquidity and capital resources

Operating activities: Cash provided from continuing operations was $662 million. Income from continuing operations before depreciation and amortization, deferred income taxes, and special charges, excluding the $21 million gain on sale of interest in joint venture, generated cash of $917 million, up from $692 million in 1996. A significant portion of the cash generated was consumed by payments with respect to workforce reductions of $197 million and net increases in working capital elements of $13 million. As a result of these payments, the workforce reduction accruals have been reduced to $458 million as at December 31, 1997. Cash payments with respect to workforce reductions are expected to be approximately $177 million in 1998. The Company continues to evaluate the workforce reduction accruals in light of the ongoing implementation of specific programs to reduce its workforce. Management believes that these accruals are adequate for future cash payments required under the programs that have been completed or are currently underway.

Cash tax payments were $10 million for the year ended December 31, 1997 consisting primarily of Canadian Federal Large Corporations Tax. As at December 31, 1997, the Company had net loss carryforwards and other temporary differences for Canadian federal tax purposes of approximately $1,000 million, such that it does not expect to make any significant cash payments for Canadian federal income taxes prior to 1999.

Investing activities: Cash used in investing activities in 1997 amounted to $424 million, net of proceeds from disposals of $145 million, compared to proceeds of disposal of $64 million in 1996. Capital expenditures amounted to $577 million in the year ended December 31, 1997, an increase of 16% over 1996. Capital expenditures included roadway renewal, rolling stock and Intermodal equipment additions and other capacity and productivity improvements. The Company anticipates that capital expenditures net of salvage proceeds for 1998 through 2000 will aggregate approximately $1,725 million and be approximately equal in each of the three years. This will include funds required for ongoing renewal of the basic plant, the locomotive upgrade program, railcar acquisitions for targeted market opportunities and other acquisitions and investments required to improve the Company's operating efficiency and customer service. Included in such expenditures is approximately $190 million for the planned acquisition of new locomotives.

Except for the proposed Illinois Central acquisition, as discussed below, the Company expects that it will be able to fund all or substantially all of its capital expenditures through 1999 with cash generated from operations (other than equipment financing and borrowings for short-term working capital needs in the ordinary course of business). As at December 31, 1997, the Company had commitments to acquire locomotives and freight cars at a cost of $206 million, rail at a cost of $29 million, railway ties at a cost of $16 million and automotive equipment at a cost of $12 million.

Dividends: The Company paid four quarterly dividends to its shareholders at the rate of $0.23 per share and in the overall amount of $78 million during 1997.

Financing activities: Financing activities provided cash of $119 million. New debt issues, principally in capital leases, totalling $213 million were mainly for the financing of new locomotives under the locomotive upgrade program. The Company has no significant long-term indebtedness maturing prior to May 1999. Any short-term working capital deficiency is expected to be financed under committed revolving credit facilities. The Company has entered into credit agreements providing for committed revolving credit facilities of Cdn $275 million and U.S. $138 million for a five-year term arranged through a syndicate of financial institutions. The facilities provide for various types of loans at varying rates based on certain benchmark rates, including the Canadian Prime Rate, the U.S. Base Rate, the U.S. Federal Funds Effective Rate and the London Interbank Offer Rate, and on the Company's credit rating at the time of drawdown. For the year ended December 31, 1997, the Company has not drawn down on the credit facilities.

Discontinued operations: During 1997, the Company paid $20 million for obligations related to previously discontinued operations.

Business risks

Environment

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railway operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities.

As at December 31, 1997, the Company had aggregate accruals for environmental costs of $76 million ($87 million at December 31, 1996). During the year, $11 million was charged to the provision for environmental costs compared to $11 million in 1996, and $9 million in 1995. In addition, related environmental capital expenditures were $13 million for 1997, $13 million in 1996 and $5 million in 1995. The Company also expects to incur capital expenditures relating to environmental matters of approximately $13 million in 1998, $15 million in 1999 and $7 million in 2000. The Company has not included any reduction in costs for anticipated recovery from insurance.

Legal actions

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1997 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

Labour negotiations

The Company's collective agreements with all unions expired on December 31, 1997. The Company is currently in negotiation with bargaining units in Canada and the United States. In Canada, conciliation talks with the Canadian Auto Workers are continuing, but the union has indicated publicly that it wants government permission to set a strike deadline. The union's members have also taken a strike vote in anticipation of obtaining such government permission. In the United States, the Company is engaged in mediation with two units. Under the mediation process, parties are required to continue discussions until the mediator declares an impasse and releases the parties. There is no time limit on the duration of the mediation phase. If such mediation is unsuccessful, the union could commence a work stoppage as early as 30 days after the declaration of an impasse by the mediator. A strike would likely have the effect of shutting down certain of the Company's operations for the duration of the strike. Such a strike may materially adversely affect the Company's results of operations.

Year 2000

Information systems are significant to the day-to-day operations of the Company. Failure to achieve Year 2000 compliance by the Company, other railroads, customers, partners or suppliers could materially adversely affect the Company's operations.

In 1996, the Company implemented a plan to ensure that all of its computer systems are Year 2000 ready including the identification of operating and information systems and equipment which require remedial action. The systems plan is well into execution with core traffic systems already completed and support systems scheduled in order of criticality for completion by December 1998. Detailed plans and accountability have been identified for process control, equipment, buildings, networks, desktops, user support systems, suppliers, partners, and customers. Business interruption and contingency plans are either in place or under development for all critical areas.

An Executive Steering Committee and Program Management Office have been established to focus all actions that must be taken to ensure the Company minimizes the risks associated with the Year 2000 issue. Progress toward Year 2000 compliance is monitored on a regular basis by the Senior Executive Committee of the Company as well as the Audit and Finance Committee of the Board of Directors. The Company is on track to complete all critical components of the plan by the end of 1998.

While there can be no assurance that the Company will not be materially adversely affected by Year 2000 problems, the Company is committed to ensuring that it is fully Year 2000 ready. Based on current information, the Company does not believe any issues relating to the Year 2000 will have a material adverse effect on its financial condition or its results from operations. Expenditures for the necessary modifications will be required over 1998 and 1999 and are not expected to have a significant impact on the Company's results of operations.

Financial instruments

Although the Company conducts its business and receives revenues primarily in Canadian dollars, a portion of its business is conducted and revenues are denominated in U.S. dollars. Thus, the Company's results are affected by fluctuations in the exchange rate between these currencies. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby affects the Company's revenues.

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to nonperformance by the counterparty to its foreign currency swap are not anticipated. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is constantly monitored.

The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. The Company has entered into various swaps and collar agreements to mitigate the risk of fuel price volatility. The Company also monitors its hedging positions and credit ratings of its counterparties and does not anticipate losses due to counterparty nonperformance. At December 31, 1997, the Company has hedged approximately 28% of the estimated 1998 fuel consumption. Unrecognized losses from the Company's fuel hedging activities were immaterial at December 31, 1997.

Other risks

In any given year CN, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume the freight it transports. Many of the goods and commodities carried by the Company experience cyclicality in demand. However, many of the bulk commodities CN transports move offshore and are impacted more by global economic conditions than North American economic cycles. The Company's results of operations can be expected to reflect this cyclicality because of the significant fixed costs inherent in railroad operations. The Company's revenues are affected by prevailing economic conditions, and should an economic slowdown or recession occur in North America or other key markets, the volume of rail shipments carried by the Company is likely to be reduced.

In addition to the inherent risks of the business cycle, the Company is occasionally susceptible to severe weather conditions. For example, in late 1996 and the first quarter of 1997, CN's operations in western Canada were impacted by heavy snowfalls and severe cold weather which caused blockages on the main line serving Vancouver and led to equipment failures, temporarily halting train operations.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as CN, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

Accounting principles

All financial information reflected herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles which conform, in all material respects, with those generally accepted in the United States except as discussed in Note 20 to the Consolidated Financial Statements. The major differences between Canadian and U.S. GAAP affecting income are the accounting for track replacement costs, pension costs, the treatment of unrealized foreign currency exchange gains and losses on long-term monetary items, the recognition of compensation expense related to stock-based compensation, the treatment of joint ventures and the classification of costs to redeem, repurchase and defease long-term debt. New accounting recommendations from the Canadian Institute of Chartered Accountants have eliminated the differences that existed between Canadian and U.S. GAAP with regards to accounting for income taxes.

On an on-going basis, the Company analyzes and compares its financial results to those of major U.S. railroads. In this regard, the Company has undertaken a study of the accounting policies and practices of U.S. railroads under U.S. GAAP. U.S. railroads generally capitalize material, labour and allocable indirect costs associated with track replacement programs. Under Canadian GAAP, CN only capitalizes material costs for replacement programs. As a result, compared to U.S. railroads, CN has recognized a higher proportion of labour and indirect costs attributable to track replacement programs as operating costs and consequently a lower depreciation expense attributable to a lower capitalized property cost base. The effect of reconciling CN's other accounting policies and practices to those of other major U.S. railroads, for the differences identified to date, resulted in the reclassification of certain revenue and expense items not impacting operating income.

To permit a better comparison between CN and other U.S. class I railroads, the Company has announced that, effective in 1998, it will prepare and report financial results in accordance with U.S. generally accepted accounting principles. In addition, effective in 1997, the Company has changed its accounting

policy for U.S. GAAP for track replacement costs. However, the Company will continue to provide financial statements in accordance with Canadian generally accepted accounting principles consistent with railway industry practices in Canada which generally are governed by the Canadian Transportation Agency under the Uniform Classification of Accounts rules.

Under Canadian GAAP, the Company has designated certain future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars, and as a result the related unrealized foreign currency translation gains or losses are deferred and recognized in net income at the earlier of the debt repayment or such time as the hedge ceases to be effective. Such foreign exchange gains or losses will be offset by foreign currency gains or losses resulting from the U.S. dollar revenue stream. Unrealized foreign currency gains or losses related to long-term debt denominated in U.S. dollars not covered by the hedge are deferred and amortized over the remaining life of the debt. Such deferred amounts are included in the consolidated balance sheet as part of Other assets and deferred charges.

Proposed Canadian National – Illinois Central merger

In February 1998, the Company and Illinois Central Corporation (IC) entered into a merger agreement pursuant to which the Company would acquire all of the common stock of IC for a combination of cash and stock valued at U.S.$39.00 per share. IC has approximately 61.4 million shares outstanding giving the transaction a total equity value of U.S.$2.4 billion. The merger agreement was unanimously approved by the directors of both companies on February 10, 1998. Pursuant to the terms of the merger agreement, the Company commenced a cash tender offer on February 13, 1998 for approximately 46.1 million shares of IC common stock, representing approximately 75% of the outstanding IC common stock. The tender offer is subject to a minimum tender condition of 50.1% of the fully diluted IC common shares being validly tendered and not withdrawn. The tender offer will be subject to receipt of informal U.S. Surface Transportation Board (STB) staff approval of a required voting trust agreement and the satisfaction of other customary conditions.

The tender offer to acquire up to 75% of the common stock of IC will require the Company to disburse cash of approximately U.S.$1.8 billion which will be financed by a term loan facility (Term Facility) for U.S.$800 million and a revolving credit facility (Revolving Facility) for U.S.$1 billion. The Company anticipates that the facilities will be repaid from a variety of sources including funds generated internally, bank refinancings and the public or private sale of debt or equity securities. No final decisions have been made concerning the sources and methods employed to repay such indebtedness. Such decisions will be made and may be modified by the Company based on prevailing market conditions and such other factors as the Company may deem appropriate.

Following the completion of the tender offer, the Company will consummate the merger in which the remaining IC shares will be exchanged for cash and CN shares at a value equal to the same cash price paid in the tender offer, subject to certain collar arrangements. The merger is subject to, among other things, approval by IC shareholders and other customary conditions. All IC shares acquired by the Company in either the tender offer or merger will be placed in a voting trust. As such, the Company will not be able to exercise control over IC until the STB approves the Company's acquisition of control of IC. The STB could impose conditions or restrictions as it relates to the Company's acquisition of control of IC. If the STB does not approve the Company's acquisition of control of IC or if the Company deems any conditions imposed by the STB unacceptable, the Company would be obligated to sell all IC common shares held by the voting trust. Such a disposition could materially adversely affect the Company's financial condition and results of operations. Neither the acquisition of the IC shares pursuant to the tender offer nor the merger will be subject to STB approval of the combination.

Until STB approval, the Company will account for its investment in IC using the equity method. Upon receipt of STB approval, the transaction will be accounted for using the purchase method. Although the purchase price allocation will not be finalized until the STB renders its decision, initial estimates indicate that the purchase price will exceed the fair market value of the tangible assets to be acquired.

MANAGEMENT REPORT

The accompanying consolidated financial statements of Canadian National Railway Company and all information in this annual report are the responsibility of management and have been approved by the board of directors.

The financial statements have been prepared by management in conformity with Canadian generally accepted accounting principles. These statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

Management of the Company, in furtherance of the integrity and objectivity of data in the financial statements, has developed and maintains a system of internal accounting controls and supports an extensive program of internal audits. Management believes that this system of internal accounting controls provides reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements and that assets are properly accounted for and safeguarded.

The board of directors carries out its responsibility for the financial statements in this report principally through its audit and finance committee, consisting solely of outside directors. The audit and finance committee reviews the Company's annual consolidated financial statements and recommends their approval by the board of directors. Also, the audit and finance committee meets regularly with the Chief, Internal Audit, and with the shareholders' Auditors.

These consolidated financial statements have been audited by the shareholders' Auditors, KPMG, whose report is presented below.

Michael J. Sabia
Executive Vice-President and Chief Financial Officer

January 20, 1998

AUDITORS' REPORT

To the shareholders of
Canadian National Railway Company

We have audited the consolidated balance sheets of Canadian National Railway Company as at December 31, 1997 and 1996 and the consolidated statements of income, shareholders' equity and changes in financial position for each of the years in the three-year period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1997 and 1996, and the results of its operations and the changes in its financial position for each of the years in the three-year period ended December 31, 1997, in accordance with generally accepted accounting principles.

KPMG

KPMG
Chartered Accountants

Raymond Chabot Grant Thornton

Raymond Chabot Grant Thornton
General Partnership
Chartered Accountants
(For the year ended December 31, 1995)

Montreal, Canada,
January 20, 1998 (February 13, 1998 as to Note 22)

CONSOLIDATED STATEMENT OF INCOME

In millions *Year ended December 31*	**1997**	1996 (restated)	1995 (restated)
Revenues			
Industrial products	**$ 893**	$ 851	$ 838
Forest products	**824**	787	771
Grain and grain products	**692**	564	600
Coal, sulphur, and fertilizers	**635**	618	601
Intermodal	**776**	677	635
Automotive	**435**	389	399
Other items	**97**	109	110
Total revenues	**4,352**	3,995	3,954
Operating expenses			
Labour and fringe benefits	**1,431**	1,381	1,477
Material	**316**	297	318
Fuel	**335**	314	277
Depreciation and amortization	**200**	194	231
Operating taxes	**186**	171	192
Equipment rental	**219**	216	194
Net car hire	**116**	108	117
Purchased services	**363**	348	354
Casualty and insurance	**103**	85	52
Other	**276**	271	302
Special charges *(Note 10)*	**–**	381	1,453
Total operating expenses	**3,545**	3,766	4,967
Operating income (loss)	**807**	229	(1,013)
Interest expense *(Note 11)*	**(118)**	(114)	(198)
Other income *(Note 12)*	**57**	27	100
Income (loss) from continuing operations before income taxes	**746**	142	(1,111)
Income tax (expense) recovery from continuing operations *(Note 13)*	**(325)**	694	19
Income (loss) from continuing operations	**421**	836	(1,092)
Discontinued operations (net of applicable income taxes) *(Note 14)*	**(18)**	14	7
Net income (loss)	**$ 403**	$ 850	$(1,085)
Earnings per share (Note 16)			

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEET

In millions *December 31*	1997	1996 (restated)
Assets		
Current assets:		
Cash and cash equivalents	**$ 365**	$ 106
Accounts receivable *(Note 3)*	**681**	694
Material and supplies	**150**	158
Deferred income taxes *(Note 13)*	**241**	186
Other	**112**	99
	1,549	1,243
Properties *(Note 4)*	**5,122**	4,869
Deferred income taxes *(Note 13)*	**164**	522
Other assets and deferred charges	**240**	206
Total assets	**$7,075**	$6,840
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable and accrued charges *(Note 6)*	**$1,066**	$1,085
Current portion of long-term debt *(Note 8)*	**43**	27
Other	**96**	121
	1,205	1,233
Other liabilities and deferred credits *(Note 7)*	**813**	1,020
Long-term debt *(Note 8)*	**1,640**	1,499
Shareholders' equity: *(Note 9)*		
Capital stock	**2,016**	2,012
Contributed surplus	**190**	190
Retained earnings	**1,211**	886
	3,417	3,088
Total liabilities and shareholders' equity	**$7,075**	$6,840

See accompanying notes to consolidated financial statements.

On behalf of the board:

David G.A. McLean
Director

Paul M. Tellier
Director

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

In millions	Issued and outstanding common shares	Capital stock	Contributed surplus	Retained earnings	Total shareholders' equity
Balances December 31, 1994	5.9	$ 2,279	$ –	$ 378	$ 2,657
Net loss	–	–	–	(1,085)	(1,085)
Capital reorganization *(Note 9(B))*:					
Stock split	74.1	–	–	–	–
Reduction in stated capital	–	(1,300)	489	811	–
Common shares issued	4.9	1,033	–	–	1,033
Dividend in kind	–	–	(248)	–	(248)
Costs related to sale of shares	–	–	(33)	–	(33)
Other transactions	–	–	10	–	10
Related income tax effect	–	–	(28)	–	(28)
Balances December 31, 1995	84.9	2,012	190	104	2,306
Net income	–	–	–	850	850
Dividends	–	–	–	(68)	(68)
Balances December 31, 1996	84.9	2,012	190	886	3,088
Net income	–	–	–	403	403
Stock options exercised and employee share plans	0.7	4	–	–	4
Dividends	–	–	–	(78)	(78)
Balances December 31, 1997	**85.6**	**$ 2,016**	**$ 190**	**$ 1,211**	**$ 3,417**

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

In millions *Year ended December 31*	**1997**	1996 (restated)	1995 (restated)
Operating activities			
Income (loss) from continuing operations	**$ 421**	$ 836	$(1,092)
Non-cash items in income (loss):			
Depreciation and amortization *(Note 15(C))*	**202**	196	234
Deferred income taxes *(Note 13)*	**315**	(705)	–
Special charges	**–**	365	1,415
Gain on disposal of rail subsidiary's operating assets	**–**	–	(39)
Gain on sale of interest in joint venture	**(21)**	–	(5)
Changes in:			
Accounts receivable	**5**	59	(127)
Material and supplies	**7**	16	20
Accounts payable and accrued charges	**19**	142	(133)
Other net current assets and liabilities	**(44)**	(49)	23
Payments for workforce reduction	**(197)**	(307)	(245)
Other	**(45)**	4	(18)
Cash provided from continuing operations	**662**	557	33
Investing activities			
Additions to properties *(Note 15(C))*	**(577)**	(496)	(326)
Net proceeds from disposal of properties	**122**	64	82
Net proceeds from disposal of rail subsidiary's operating assets	**–**	–	50
Net proceeds from sale of interest in joint venture	**23**	–	10
Other	**8**	1	(4)
Cash used by investing activities	**(424)**	(431)	(188)
Dividends paid to shareholders	**(78)**	(68)	–
Financing activities			
Issuance of long-term debt	**213**	213	3
Reduction of long-term debt	**(98)**	(294)	(814)
Redemption of auction preferred stock	**–**	–	(271)
Issuance of capital stock *(Note 9)*	**4**	–	1,033
Costs related to the sale of shares	**–**	–	(33)
Cash provided from (used by) financing activities	**119**	(81)	(82)
Cash (used by) provided from discontinued operations *(Note 14)*	**(20)**	10	101
Net increase (decrease) in cash	**259**	(13)	(136)
Cash and cash equivalents, beginning of year	**106**	119	255
Cash and cash equivalents, end of year	**$ 365**	$ 106	$ 119

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

CN's revenues are derived from the movement of a balanced and diversified mix of commodities and products predominantly originating in Canada. The Company's network extends from Halifax to Vancouver and connects to the Chicago gateway through its subsidiary, Grand Trunk Corporation in the east, and through a haulage agreement linking Chicago to the Company's lines at Duluth in the west.

1 Summary of significant accounting policies

The consolidated financial statements are expressed in Canadian dollars and have been prepared in accordance with accounting principles generally accepted in Canada, which differ in certain respects from those in the United States as explained in Note 20. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period and the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

A. Principles of consolidation

The consolidated financial statements include the accounts of all subsidiaries together with the Company's investments in which it has joint control. These investments are accounted for using the proportionate consolidation method.

B. Revenues

Freight revenues are recognized based on the percentage of completed service method. Costs associated with movements are recognized as the service is performed.

C. Foreign exchange

The Company's U.S. operations are classified as integrated and are translated and accounted for on the following basis: monetary assets and liabilities are translated at the rates in effect at the balance sheet date, and non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates during the year except for depreciation which is translated at exchange rates prevailing when the related properties were acquired.

The Company's own foreign denominated assets and liabilities are accorded similar treatment. Revenues and expenses are translated at rates prevailing at the time of the transactions, except for revenues designated as a hedge against repayment of foreign denominated long-term debt, which are translated at the rate in effect at the inception of the debt.

Currency gains and losses are reflected in net income for the year, except for unrealized foreign currency gains and losses on long-term debt. The Company has designated certain future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars and has thus deferred reflecting the related unrealized foreign currency translation gains and losses in net income until the earlier of the debt repayment or such time as the hedge ceases to be effective. Such foreign exchange gains or losses will be offset by foreign currency gains or losses resulting from the U.S. dollar revenue stream. Unrealized foreign currency gains and losses related to long-term debt denominated in U.S. dollars not covered by the hedge are deferred and amortized over the remaining life of the debt. Such deferred amounts are included in the Consolidated Balance Sheet as part of Other assets and deferred charges.

D. Cash and cash equivalents

Cash and cash equivalents include highly liquid investments purchased three months or less from maturity and are stated at cost, which approximates market value.

E. Material and supplies

The inventory is valued at weighted average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable secondhand, obsolete, and scrap materials.

F. Properties

Railway properties are carried at cost less accumulated depreciation including asset impairment write-downs. All costs of materials associated with the installation of rail, ties, ballast, and other track improvements are capitalized to the extent they meet the Company's definition of "unit of property". The related labour and overhead costs are also capitalized for the installation of new, non-replacement track. All other labour and overhead costs and maintenance costs are expensed as incurred. Related interest costs are charged to expense. The cost of railway properties retired or disposed of, less salvage value, is charged to accumulated depreciation, in accordance with the group plan of depreciation. The Company reviews the carrying amount of prop-

erties whenever events or changes in circumstances indicate that such carrying amount may not be recoverable based on future undiscounted cash flows or estimated net realizable value. Assets that are deemed impaired as a result of such review are recorded at the lower of carrying amount or fair value.

G. Depreciation

The cost of properties, net of asset impairment write-downs, is depreciated on a straight-line basis over their estimated useful lives as follows:

Asset class	Annual rate
Ties	2.18%–3.14%
Rails	1.93%–2.58%
Other track material	2.40%–3.32%
Ballast	2.21%–4.36%
Road locomotives	3.51%–4.30%
Freight cars	0.63%–4.22%
Buildings	0.78%–5.34%

H. Pensions

Pension costs are determined periodically by independent actuaries. Pension expense is charged to operations and includes:

(i) the cost of pension benefits provided in exchange for employees' services rendered during the year,

(ii) the amortization of past service costs over the expected average remaining service life of the employee group covered by the plans, and

(iii) the interest cost of pension obligations, the return on pension fund assets, and the amortization of experience gains and losses.

The pension plans are funded through contributions determined in accordance with the accrued benefit actuarial cost method.

I. Post-retirement benefits other than pensions

The Company accrues the cost of post-retirement benefits other than pensions, which include life insurance programs, medical benefits, supplemental pension allowances, and free rail travel benefits not covered in the Company's principal pension plans. The Company funds the benefits payable as they become due.

J. Financial instruments

Derivative financial instruments may be used from time to time by the Company in the management of its interest, foreign currency, and commodity exposures. Gains or losses on such instruments entered into for the purposes of hedging its risk exposures are deferred and amortized in income over the life of the hedged asset or liability. Income and expense related to financial instruments are recorded in the same category as that generated by the underlying asset or liability.

K. Environmental expenditures

Environmental expenditures that relate to current operations are expensed or capitalized as appropriate. Expenditures that relate to an existing condition caused by past operations, and which do not contribute to current or future revenue generation, are expensed. Liabilities are recorded when environmental assessments and/or remedial efforts are likely, and when the costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required to meet the Company's environmental policy, can be reasonably estimated.

L. Income taxes

The Company follows the asset and liability method for accounting for income taxes. Under the asset and liability method, the change in the net deferred tax asset or liability is to be included in income. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled.

2 Adoption of new accounting standard

Income taxes

Effective with the fourth quarter of 1997, the Company adopted the new Canadian Institute of Chartered Accountants' (CICA) recommendations for the accounting for income taxes. The new standard requires the use of the asset and liability method for accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying values and their respective income tax basis (temporary differences). Deferred income tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is included in income in the period that includes the enactment date. Deferred income tax assets are evaluated and if realization is not considered "more likely than not", a valuation allowance is provided.

2 Adoption of new accounting standard *(continued)*

Previously, the Company followed the deferral method of accounting for income taxes which related the provision for income taxes to the accounting income for the period. Under the deferral method, the amount by which the income tax provision differed from the amount of income taxes currently payable was considered to represent the deferring to future periods of benefits obtained or expenditures incurred in the current period and accordingly was computed at current income tax rates. The accumulated income tax allocation debit or credit balance was not adjusted to reflect subsequent changes in income tax rates. Also, under the deferral method, tax benefits, related to accounting losses, could only be recognized in the period the loss was incurred if there was virtual certainty of realizing these benefits.

As a result of the change in accounting policy, an income tax recovery (including discontinued operations) of $708 million, or $8.34 per share, was recorded in 1996 for income tax benefits related to years prior to 1997. In 1997, income tax expense of $303 million, or $3.56 per share, related to income before tax was recorded. There was no effect on the comparative figures prior to 1996.

3 Accounts receivable

In millions *December 31*	**1997**	1996
Freight		
Trade	**$504**	$433
Accrued	**43**	41
Non-freight	**178**	250
	725	724
Provision for doubtful accounts	**(44)**	(30)
	$681	$694

4 Properties

In millions	*December 31, 1997*			*December 31, 1996*		
	Cost	**Accumulated depreciation**	**Net**	Cost	Accumulated depreciation	Net
Track and roadway	**$ 6,503**	**$3,107**	**$3,396**	$ 6,561	$3,247	$3,314
Buildings	**836**	**508**	**328**	833	497	336
Rolling stock	**2,248**	**1,073**	**1,175**	2,051	1,072	979
Other	**735**	**512**	**223**	758	518	240
	$10,322	**$5,200**	**$5,122**	$10,203	$5,334	$4,869
Capital leases included in properties	**$ 499**	**$ 50**	**$ 449**	$ 322	$ 40	$ 282

5 Credit facilities

The Company has available credit agreements providing for committed revolving credit facilities of Cdn $275 million and U.S. $138 million for a five-year term arranged through a syndicate of financial institutions. The facilities provide for various types of loans at varying rates based on certain benchmark rates, including the Canadian Prime Rate, the U.S. Base Rate, the U.S. Federal Funds Effective Rate, and the London Interbank Offer Rate, and on the Company's credit rating at the time of drawdown. In 1997 and 1996, the Company had not drawn down on the credit facilities.

6 Accounts payable and accrued charges

In millions *December 31*	**1997**	1996
Trade payables	**$ 314**	$ 309
Current portion of workforce reduction provisions	**177**	210
Payroll-related accruals	**172**	167
Accrued charges	**119**	69
Accrued operating leases	**112**	119
Accrued interest on long-term debt	**46**	34
Other	**126**	177
	$1,066	$1,085

7 Other liabilities and deferred credits

In millions *December 31*	**1997**	1996
Workforce reduction provisions, net of current portion *(A)*	**$281**	$ 445
Accrual for post-retirement benefits other than pensions *(B)*	**135**	126
Personal injury liability	**88**	96
Environmental liability, net of current portion	**59**	79
Deferred credits and other	**250**	274
	$813	$1,020

A. Workforce reduction provisions

The workforce reduction provisions, which cover employees in both Canada and the United States, are mainly comprised of severance payments which will be disbursed over a period of up to 7 years. Other elements of the provisions include mainly early retirement incentives and bridging to early retirement. Payments for severance and the other elements of the provisions have reduced the provisions by $197 million for the year ended December 31, 1997 ($307 million for the year ended December 31, 1996). The special charge recorded in 1996 with respect to workforce reductions had the effect of increasing the aggregate provisions to $655 million at December 31, 1996.

B. Post-retirement benefits other than pensions

(i) The following table shows the reconciliation of the plan's obligations to amounts accrued at the balance sheet dates. The Company uses a December 31 measurement date.

In millions *December 31*	**1997**	1996
Accumulated post-retirement benefit obligation:		
Retirees	**$ 65**	$ 70
Fully eligible active plan participants	**61**	50
	126	120
Unrecognized net gain	**9**	6
	$135	$126

(ii) Components of net periodic post-retirement benefit cost applicable to continuing operations are as follows:

In millions *Year ended December 31*	**1997**	1996	1995
Service cost	**$ 3**	$ 3	$ 3
Interest cost	**7**	6	6
Net amortization and deferral	**(1)**	(7)	(4)
	$ 9	$ 2	$ 5
Weighted-average discount rate	**7.44%**	8.00%	7.67%
Weighted-average (long-term) salary increase	**4.50%**	5.25%	5.25%

8 Long-term debt

In millions *December 31*	Maturity	Currency in which payable	**1997**	1996
Bonds, debentures, and notes: (A)				
Canadian National series:				
9⅝% 7-year notes	May 14, 1999	Cdn$	**$ 50**	$ 50
5⅜% 15-year Swiss franc bonds *(B)*	Aug. 22, 2000	CHF	**99**	99
8⅞% 15-year notes	May 21, 2001	Cdn$	**150**	150
6⅝% 10-year notes	May 15, 2003	U.S.$	**190**	190
7% 10-year notes	Mar. 15, 2004	U.S.$	**365**	412
7⅝% 30-year debentures	May 15, 2023	U.S.$	**190**	190
Total bonds, debentures, and notes			**1,044**	1,091
Other:				
Mortgages and other *(C)*		Cdn$	**15**	33
Amounts owing under equipment agreements *(D)*		Various	**75**	83
Capital lease obligations *(E)*		Various	**477**	291
Adjustment to current exchange rate		Various	**75**	32
Total other			**642**	439
Subtotal			**1,686**	1,530
Less:				
Current portion of long-term debt			**43**	27
Net unamortized discount			**3**	4
			46	31
			$1,640	$1,499

8 Long-term debt *(continued)*

A. The Company's bonds, debentures, and notes are unsecured.

B. The August 22, 2000 bonds issued in Swiss Francs (CHF170 million), bearing an interest rate of 5⅜% were effectively converted at their issue date to a $99 million Canadian dollar obligation through a currency swap agreement at an all-inclusive cost of 11.17%.

C. Mortgages and other loans bear interest at various rates.

D. Secured by rolling stock and payable by monthly or semi-annual installments over various periods to 2003 at interest rates ranging from 6% to 13¾%. The principal amounts are payable as follows: U.S. $19 million and Cdn $49 million as at December 31, 1997, U.S. $22 million and Cdn $53 million as at December 31, 1996.

E. Interest rates for these leases range from approximately 4¾% to 17½% with maturity dates in the years 1999 through 2016. The imputed interest on these leases amounted to $460 million as at December 31, 1997, and $269 million as at December 31, 1996.

F. Principal repayments for the following fiscal years, including repurchase arrangements and capital lease repayments on debt outstanding as at December 31, 1997 are as follows:

Year	*In millions*	Amount
1998		$ 43
1999		118
2000		159
2001		190
2002		25
2003 and thereafter		1,148

G. The aggregate amount of U.S. debt payable in U.S. currency as at December 31, 1997 is U.S. $800 million (Cdn $1,143 million) and as at December 31, 1996 is U.S. $737 million (Cdn $1,010 million).

9 Shareholders' equity

A. Authorized capital stock

The authorized capital stock of the Company is as follows:

- Unlimited number of Common Shares, without par value
- Unlimited number of Class A Preferred Shares, without par value issuable in series
- Unlimited number of Class B Preferred Shares, without par value issuable in series

B. Capital reorganization

During 1995, the CN Commercialization Act came into effect authorizing the continuance of the Company under the Canada Business Corporations Act (CBCA) and the sale of common shares of the Company owned by the Government of Canada. On November 28, 1995, the Government of Canada sold all its shares in the Company to the public. Prior to the sale of the shares, the Company carried on ordinary business transactions with various entities controlled by its previous shareholder on the same terms and conditions as transactions with unrelated parties.

Also during 1995, the Company reorganized its capital structure by: reducing its legal stated capital by an amount of $1,300 million, thereby eliminating the accumulated deficit of $811 million and creating contributed surplus of $489 million; changing the 5,868,786 common shares issued and outstanding into 79,999,999 common shares, constituting a 13.63-for-one stock split; and transferring, by way of a dividend in kind, the beneficial ownership of a substantial portion of the Company's net non-rail real estate assets, which included CN Tower, having a book value of $248 million. In addition, the Company issued 4,945,299 common shares for cash.

C. Employee share plans

(i) As part of the public offering in 1995, eligible employees purchased shares under the employee share plan. The Company provided non-interest bearing loans of up to 90% of the share purchase price to eligible employees. During 1997, the Company issued a total of 512,687 common shares (matched shares) to those employees whose shares in the plan had vested during the year. An additional 69,139 common shares will be issued by the Company after meeting their vesting requirements.

(ii) An Employee Share Investment Plan (ESIP) was implemented, effective September 1, 1997, giving eligible employees the opportunity to subscribe for up to 6% of their gross salaries to purchase shares of the Company's common stock on the open market and to have the Company invest, on the employee's behalf, a further 35% of the amount invested by the employee. Participation at December 31, 1997 was 1,893 employees. At December 31, 1997, the total number of ESIP shares purchased on behalf of employees was 19,203.

D. Stock options

The Company has implemented stock option plans for eligible managers to acquire common shares of the Company at a price equal to the market value of the common shares at the date of granting. One-third of the options (the conventional options) vest over four years and have a term of ten years from the date of granting. Two-thirds of the options (the performance options) vest upon the attainment by the Company of targets relating to the operating ratio. These performance options are scheduled to expire in the years 2001 and 2003.

Changes in the Company's stock options are as follows:

	Number of options	Weighted average exercise price	Options exercisable
	In millions		*In millions*
Outstanding at January 1, 1995	Nil	N/A	Nil
Granted	1.0	$27.00	
Outstanding at December 31, 1995	1.0	$27.00	Nil
Granted	0.6	$37.20	
Cancelled	(0.1)	$29.32	
Outstanding at December 31, 1996	1.5	$31.14	0.2
Granted	0.6	$56.59	
Cancelled	(0.2)	$29.50	
Exercised	(0.1)	$31.06	
Outstanding at December 31, 1997	**1.8**	**$38.87**	**0.5**

Stock options outstanding as at December 31, 1997, were as follows:

	Range of exercise prices	Number of options	Weighted average years to expiration	Weighted average exercise price
		In millions		
Options granted in 1995	$27.00	0.7	5	$27.00
Options granted in 1996	$37.04–$47.44	0.6	5	$37.23
Options granted in 1997	$49.70–$77.50	0.5	6	$56.52
Outstanding at December 31, 1997		**1.8**		**$38.87**

10 Special charges

A. Workforce reductions

The Company recorded a $365 million charge to operations in the fourth quarter of 1996 for workforce reduction plans aimed at reducing future operating costs and increasing productivity. The charge included severance and other payments to be made for approximately 2,250 reductions, a substantial majority of which occurred in the fourth quarter of 1996 and 1997. The majority of the planned 1997 reductions were completed during 1997 but payments will occur throughout the next seven years. Labour productivity initiatives span the entire organization with reductions in the administration, transportation, engineering and equipment functions.

B. Debt reduction costs

The charge to operations of the costs to redeem, repurchase or defease debt in 1996 and 1995 amounted to $16 million and $38 million respectively.

C. Asset impairment

During the second quarter of 1995, the Company undertook an asset impairment analysis which indicated that the net carrying values of certain of its rail properties were impaired. As a result, on June 30, 1995, the Company recorded a charge to operations and an increase in accumulated depreciation of $1,300 million. The amount of the impairment was established by comparing the future undiscounted net cash flow related to the eastern operations with the carrying amount of the eastern rail properties.

D. Environmental accrual

During the second quarter of 1995, the Company completed a review of potential environmental costs and liabilities. As a result of this review, the Company recorded a charge to operations for future environmental costs of $88 million. The current portion of the provision giving rise to these charges is included in the Consolidated Balance Sheet as part of Other current liabilities and the balance as part of Other liabilities and deferred credits.

E. Other

Other 1995 special charges are comprised of a write-down of material and supplies of $14 million and a provision for legal actions in the amount of $13 million.

11 Interest expense

In millions *Year ended December 31*	**1997**	1996	1995
Interest on long-term debt	**$122**	$110	$214
Interest on short-term borrowings	**2**	7	4
Interest income	**(6)**	(3)	(20)
Total continuing operations	**$118**	$114	$198
Cash interest payments for continuing operations	**$110**	$119	$240

12 Other income

In millions *Year ended December 31*	1997	1996	1995
Gain on sale of interest in joint venture	**$ 21**	$ –	$ –
Gain on disposal of rail subsidiary's operating assets	**–**	–	39
Gain on disposal of properties	**37**	26	44
Net rental income (loss)	**(8)**	(7)	1
Investment income	**9**	10	18
Income (loss) from Canac International	**(2)**	(1)	2
Other	**–**	(1)	(4)
	$ 57	$ 27	$100

13 Income taxes

The Company's income tax (expense) recovery from continuing operations is as follows:

In millions *Year ended December 31*	1997	1996	1995
Combined basic Canadian federal and provincial tax rate (combined basic tax rate)	**44.4%**	44.4%	41.9%
Income tax (expense) recovery from continuing operations based on the combined basic tax rate	**$(331)**	$ (63)	$ 466
Income tax (expense) recovery resulting from:			
Federal large corporations tax and other cash taxes	**(10)**	(11)	(13)
Gain on disposal of properties	**4**	5	6
Other	**12**	(5)	(9)
Recognition of income tax benefits related to prior years	**–**	768	–
Losses for which an income tax benefit has not been recognized	**–**	–	(431)
Income tax (expense) recovery from continuing operations	**$(325)**	$ 694	$ 19
Income tax (expense) recovery from continuing operations is represented by:			
Current	**$ (10)**	$ (11)	$ (13)
Deferred	**(315)**	705	–
Income taxes related to dividend in kind and other	**–**	–	32
	$(325)	$ 694	$ 19
Income tax recovery (expense) related to discontinued operations	**$ 12**	$ (3)	$ (4)
Cash payments for income taxes	**$ 10**	$ 11	$ 13

Significant components of deferred income tax assets and liabilities are as follows:

In millions *December 31*	1997	1996
Assets		
Loss carryforwards	**$165**	$264
Workforce reduction provisions	**178**	249
Accruals and other reserves	**42**	55
Post-retirement benefits	**45**	42
Properties	**–**	98
	430	708
Liabilities		
Properties	**25**	–
	25	–
Total net deferred income tax asset	**405**	708
Less: current portion	**241**	186
Total long-term portion of net deferred income tax asset	**$164**	$522

14 Discontinued operations

Consistent with the Company's plan to focus resources on operating a transportation network, in late 1997, the Company adopted a formal plan to exit its telecommunication business operated by a subsidiary.

In late 1996, the company sold all the shares of CN France S.A., a wholly owned subsidiary, to Scribe Gestion S.A. The net proceeds retained by the Company resulted in a gain of $14 million.

During 1995, the Company disposed of CN Real Estate and CN Tower by transferring beneficial ownership of a substantial portion of the Company's net non-rail real estate assets, by way of dividend in kind (see Note 9) and by selling the remaining assets for a gain before income taxes of $61 million.

In addition, in 1995, the Company undertook a formal plan to dispose of AMF Technotransport Inc., (AMF). In January 1996, AMF was sold to GEC Alsthom Canada.

A. Income (loss) from discontinued operations

Amounts included in the Consolidated Statement of Income are comprised as follows:

In millions *Year ended December 31*	**1997**	1996	1995
Net income (loss):			
AMF Technotransport	**$ –**	$ –	$ (12)
CN Exploration	**–**	–	1
CN Real Estate	**–**	–	1
CN Tower	**–**	–	2
CN France	**–**	4	1
Telecommunication business	**(6)**	(4)	–
Net income (loss) from discontinued operations	**(6)**	–	(7)
Provision for loss on disposal of telecommunication business activities, net of income tax recovery of $8 million	**(12)**	–	–
Gain on disposal of investment in CN France, net of income taxes of $6 million	**–**	14	–
Gain on disposal of oil and gas assets, net of income taxes of $18 million	**–**	–	25
Gain on disposal of real estate assets, net of income taxes of $25 million	**–**	–	36
Provision for loss on disposal of AMF, net of income tax recovery of $33 million	**–**	–	(47)
	(12)	14	14
Discontinued operations (net of applicable income taxes)	**$(18)**	$ 14	$ 7

B. Net assets (liabilities) of discontinued operations

Amounts included in the Consolidated Balance Sheet are comprised as follows:

In millions *December 31*	**1997**	1996
Current assets	**$18**	$20
Other assets and deferred charges	**6**	2
Total assets	**24**	22
Current liabilities	**28**	8
Total liabilities	**28**	8
Net assets (liabilities)	**$ (4)**	$14

C. Net increase (decrease) in cash

Amounts included in the Consolidated Statement of Changes in Financial Position are comprised as follows:

In millions *Year ended December 31*	**1997**	1996	1995
Operating activities	**$(20)**	$ (6)	$ 8
Investing activities	**–**	17	437
Financing activities	**–**	(1)	(344)
Cash (used by) provided from discontinued operations	**$(20)**	$10	$ 101

15 Segmented information

A. Geographic areas

Virtually all of the Company's operations and assets are within Canada with the exception of U.S. rail operations.

B. International traffic

In addition to the revenue generated by U.S. rail operations, the Company derives revenue from Canadian rail operations originating or terminating on railroads in the United States. These revenues amounted to approximately $997 million in 1997, $905 million in 1996, and $750 million in 1995.

C. Additional information on segments

In millions *Year ended December 31*	**1997**	1996	1995
Revenues:			
Canadian rail	**$ 3,772**	$ 3,421	$ 3,425
U.S. rail	**580**	574	529
	$ 4,352	$ 3,995	$ 3,954
Operating income (loss):			
Canadian rail	**$ 730**	$ 205	$ (822)
U.S. rail	**77**	24	(191)
	$ 807	$ 229	$(1,013)
Income (loss) from continuing operations:			
Canadian rail	**$ 373**	$ 867	$ (959)
U.S. rail	**48**	(31)	(133)
	$ 421	$ 836	$(1,092)

15 Segmented information *(continued)*

In millions *Year ended December 31*	**1997**	1996	1995
Depreciation and amortization:			
Canadian rail *(i)*	**$ 192**	$ 186	$ 221
U.S. rail	**10**	10	13
	$ 202	$ 196	$ 234
Capital expenditures: (ii)			
Canadian rail *(iii)*	**$ 529**	$ 464	$ 288
U.S. rail	**48**	32	38
	$ 577	$ 496	$ 326

In millions *December 31*	**1997**	1996
Identifiable assets:		
Canadian rail	**$ 6,606**	$ 6,400
U.S. rail	**445**	418
	7,051	6,818
Discontinued operations	**24**	22
	$ 7,075	$ 6,840

(i) Includes $2 million (1996: $2 million, 1995: $3 million) depreciation and amortization of properties related to net rental income.

(ii) Represents additions to properties.

(iii) Includes $5 million (1996: $1 million, 1995: $1 million) additions of properties related to net rental income.

16 Earnings (loss) per share

Year ended December 31	**1997**	1996	1995
Basic earnings (loss) per share			
Income (loss) from continuing operations	**$4.95**	$ 9.85	$(13.57)
Net income (loss)	**$4.74**	$10.01	$(13.49)
Basic earnings per share (excluding special charges)			
Income from continuing operations	**$4.95**	$12.39	$ 4.49
Net income	**$4.74**	$12.56	$ 4.57
Weighted average number of common shares outstanding *(millions)*	**85.1**	84.9	80.4

Earnings (loss) per share have been calculated using the weighted average number of common shares outstanding during the year after giving retroactive effect to the stock split of November 9, 1995. The 1996 earnings per share figures have been restated to include the effects of the retroactive application of the new Canadian Institute of Chartered Accountants (CICA) recommendations on income taxes.

17 Pensions

The Company has retirement benefit plans covering substantially all its employees under which they are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions.

The actuarial valuations as at December 31, 1996 indicated a consolidated actuarial liability of $8,192 million and a consolidated actuarial asset value of $8,091 million. It is estimated that those amounts approximate $8,440 million and $8,580 million respectively as at December 31, 1997. Subsequent actuarial valuations will determine the actuarial values at that date.

In millions *Year ended December 31*	**1997**	1996	1995
Pension expense	**$ 50**	$ 48	$ 96
Pension contributions	**$ 68**	$ 81	$ 96

The information below relates to the CN Pension Plan, the Company's main pension plan. The Company's other pension plans are not significant.

A. Description of plan

The CN Pension Plan ("the Pension Plan") is a contributory defined benefit pension plan that covers all CN employees. It provides for pensions based mainly on years of service and final average pensionable earnings and is generally applicable from the first day of employment. Indexation of pensions is provided after retirement through a gain (loss) sharing mechanism, subject to guaranteed minimum increases. An independent trust company is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds). As Trustee, the trust company performs certain duties which include holding legal title to the assets of the CN Pension Trust Funds and ensuring that the Company, as Administrator, complies with the provisions of the Pension Plan and the related legislation.

B. Funding policy

Employee contributions to the Pension Plan are determined by the plan rules. Company contributions are in accordance with the requirements of the Government of Canada legislation, The Pension Benefits Standards Act, 1985, and are determined by actuarial valuations conducted at least on a triennial basis. These valuations are made in accordance with legislative requirements and with the Recommenda-

tions of the Canadian Institute of Actuaries for the valuation of pension plans.

C. Description of fund assets

The assets of the CN Pension Plan are separately accounted for in the CN Pension Trust Funds. These assets consist of cash and short-term investments, bonds, mortgages, Canadian and foreign equities, real estate, and oil and gas assets.

18 Major commitments and contingencies

A. Leases

The Company's commitments as at December 31, 1997, under operating and capital leases, totalled $1,364 million and $937 million respectively, with annual net minimum payments in each of the five following fiscal years to 2003 and thereafter, as follows:

Year *In millions*	Operating	Capital
1998	$ 235	$ 59
1999	194	88
2000	174	58
2001	176	57
2002	160	28
2003 and thereafter	425	647
	1,364	937
Less: imputed interest on capital leases at rates ranging from 4¾% to 17½%		460
Present value of minimum lease payments included in debt		$477

B. Other commitments

As at December 31, 1997, the Company had commitments to acquire locomotives and freight cars at an aggregate cost of $206 million, rail at a cost of $29 million, railway ties at a cost of $16 million, and automotive equipment at a cost of $12 million. Further, as at December 31, 1997 the Company had entered into agreements with fuel suppliers to purchase approximately 60% of its anticipated 1998 volume at prevailing market prices on the date of purchase.

C. Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions for such items which it considers to be adequate. While the final outcome with respect to actions outstanding or pending as at December 31, 1997 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company's financial position.

On July 20, 1995, the Company was advised by counsel to the National Council of CN Pensioners' Associations Inc. (the "National Council") that the latter intended to commence proceedings against the Company seeking payment of approximately $175 million, plus interest, to the CN Pension Trust Fund in connection with allegedly improper contribution holidays taken in the 1983 and 1984 fiscal periods. The Company has investigated the matter and believes that it has reasonable and meritorious arguments to defend against such proceedings, should suit be filed, which has not yet materialized.

D. Environmental matters

The Company's operations are subject to federal, provincial, state, municipal and local regulations under environmental laws and regulations concerning, among other things, emissions into the air, discharges into waters, the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances, and other materials, decommissioning of underground and aboveground storage tanks, and soil and groundwater contamination. A risk of environmental liability is inherent in the railroad and related transportation operations, real estate ownership, operation or control, and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railway operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

18 Major commitments and contingencies *(continued)*

(i) the lack of specific technical information available with respect to many sites;

(ii) the absence of any government authority, third party orders, or claims with respect to particular sites;

(iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;

(iv) the ability to recover costs from any third parties with respect to particular sites; and,

therefore the likelihood of any such costs being incurred or whether such costs would be material to the Company cannot be determined at this time. Therefore, there can be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs. Although the effect on operating results and liquidity cannot be reasonably estimated, management believes, based on current information, that environmental matters will not have a material adverse effect on the Company's financial condition or competitive position. Costs related to any future remediation will be accrued in the year in which they become known.

As at December 31, 1997, the Company had aggregate accruals for environmental costs of $76 million ($87 million as at December 31, 1996). During the year, $11 million was charged to the provision for environmental costs compared to $11 million in 1996, and $9 million in 1995. In addition, related environmental capital expenditures were $13 million in 1997, $13 million in 1996 and $5 million in 1995. The Company also expects to incur capital expenditures relating to environmental matters of approximately $13 million in 1998, $15 million in 1999, and $7 million in 2000. The Company has not included any reduction in costs for anticipated recovery from insurance.

19 Financial instruments

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. The Company has entered into a forward exchange contract (currency swap) with respect to its 15-year Swiss franc bonds. This forward exchange contract acts as a hedge to effectively fix the amount of Canadian dollars required over the term of the debt to make all necessary payments in the foreign currency of issue. The Company has not incurred any significant net gains or losses in respect of this transaction. Losses due to nonperformance by the counterparty to its foreign currency swap are not anticipated. Collateral or other security to support financial instruments subject to credit risk is usually not obtained. However, the credit standing of counterparties is constantly monitored.

The Company has a hedging program in place to mitigate the effects of fuel price changes on its operating margins and overall profitability. The Company has entered into various swaps and collar agreements to mitigate the risk of fuel price volatility. The Company also monitors its hedging positions and credit ratings of its counterparties and does not anticipate losses due to counterparty nonperformance. At December 31, 1997, the Company has hedged approximately 28% of the estimated 1998 fuel consumption. Unrecognized losses from the Company's fuel hedging activities were immaterial at December 31, 1997.

Generally accepted accounting principles define the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company uses the following methods and assumptions to estimate the fair value of each class of financial instruments for which the carrying amounts are included in the Consolidated Balance Sheet under the following indicated captions:

A. Cash and cash equivalents, trade receivables, trade payables and other current liabilities:
The carrying amounts approximate fair value because of the short maturity of those instruments.

B. Other assets and deferred charges:
Investments: The Company has various debt and equity investments for which the carrying value approximates the fair value of these investments.

C. Long-term debt:
The fair value of the Company's long-term debt is estimated based on the quoted market prices for the same or similar debt instruments.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments as at December 31, 1997 and 1996 for which the carrying value is not disclosed on the Consolidated Balance Sheet or for which the carrying amounts are different than the fair values.

In millions	*December 31, 1997*		*December 31, 1996*	
	Carrying amount	**Fair value**	Carrying amount	Fair value
Financial assets				
Investments	**$ 51**	**$ 51**	$ 59	$ 59
Financial liabilities				
Long-term debt	**$1,640**	**$1,694**	$1,499	$1,538

20 Reconciliation of Canadian and United States generally accepted accounting principles

The consolidated financial statements of Canadian National Railway Company are expressed in Canadian dollars and are prepared in accordance with Canadian generally accepted accounting principles (GAAP), which conform, in all material respects, with those generally accepted in the United States except as described below:

A. Reconciliation of net income

The application of U.S. GAAP would have the following effects on the net income (loss) as reported:

In millions *Year ended December 31*	**1997**	1996 (restated)	1995 (restated)
Income (loss) from continuing operations – Canadian GAAP	**$ 421**	$836	$(1,092)
Adjustments in respect of:			
Property capitalization, net of depreciation	**139**	–	–
Foreign exchange	**(43)**	6	33
Pension costs	**9**	4	(1)
Capitalization of interest	**–**	–	5
Compensation expense related to stock-based compensation	**(17)**	(14)	–
Loss on extinguishment of long-term debt	**–**	16	38
Income tax expense	**(40)**	–	–
Income (loss) from continuing operations – U.S. GAAP	**469**	848	(1,017)
Discontinued operations	**(18)**	14	7
Extraordinary item – loss on extinguishment of long-term debt	**–**	(16)	(38)
Cumulative effect of change in accounting policy	**589**	–	–
Net income (loss) – U.S. GAAP	**$1,040**	$846	$(1,048)

(i) Change in accounting policy – Property capitalization
Under Canadian GAAP, the Company capitalizes only the material component of track replacement costs, whereas effective January 1, 1997, under U.S. GAAP the labour, material and related overheads are capitalized. U.S. GAAP requires that the cumulative capitalization adjustment, including special charges (net of applicable income taxes) be reflected in net income in the year in which the policy is adopted ($589 million).

(ii) Foreign exchange
U.S. GAAP requires immediate recognition in income of unrealized foreign currency exchange gains and losses on long-term monetary items with a fixed or ascertainable life whereas Canadian accounting principles require that these unrealized gains and losses be deferred and amortized. In addition, under U.S. GAAP, future revenue streams from operations do not qualify as a hedge of long-term debt denominated in U.S. dollars.

(iii) Pension expense
Canadian GAAP requires that the discount rate used should represent management's best estimate of the long-term rate of return on the pension fund assets. Under U.S. GAAP, the discount rate to be used should reflect the rate at which the pension benefits can be effectively settled at the date of the financial statements. The difference in discount rates impacts annual pension expense.

(iv) Interest
The Company generally expenses interest costs related to the construction of properties. U.S. GAAP requires that this interest cost be capitalized on major construction projects.

(v) Stock-based compensation
U.S. GAAP requires the measurement and recognition of compensation expense related to certain stock-based compensation. The Company has accounted for stock-based compensation for U.S. GAAP purposes in accordance with Accounting Principles Board Opinion 25 (APB Opinion 25). The difference between compensation expense measured in accordance with APB Opinion 25 and the amount which would have been recognized under Statement of Financial Accounting Standards 123 (FAS 123) is not material. There are no similar requirements under Canadian GAAP.

20 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

(vi) Loss on extinguishment of long-term debt

Under U.S. GAAP, the loss on extinguishment of long-term debt, which is included in special charges for Canadian GAAP purposes, would have been treated as an extraordinary item.

(vii) Income taxes

In the fourth quarter of 1997, the Company adopted the new accounting recommendations for Canadian GAAP related to the accounting for income taxes which require retroactive application and restatement of comparative figures. The effect of the adoption of the accounting recommendations and restatement of financial statements was an increase in 1996 net income of $708 million. These recommendations are consistent, in all material respects, with U.S. GAAP. Under U.S. GAAP, the Company had previously reversed its valuation allowance amounting to $708 million in 1996.

(viii) New accounting recommendations

In 1997, FAS 130 ("Reporting Comprehensive Income") and FAS 131 ("Disclosure About Segments of an Enterprise and Related Information") were issued. Neither statement is expected to have a material effect on the Company's financial statements.

B. Earnings (loss) per share

In 1997, the Company retroactively adopted the new Statement of Financial Accounting Standards (FAS 128) for computing and presenting earnings per share (EPS). As a result, the EPS figures previously reported in 1996 and 1995 have been restated to conform with FAS 128 adopted in the current year.

(i) Basic earnings (loss) per share

Year ended December 31	**1997**	1996	1995
Income (loss) from continuing operations – U.S. GAAP	**$ 5.51**	$ 9.99	$(12.64)
Discontinued operations	**(0.21)**	0.16	0.08
Extraordinary item – loss on extinguishment of long-term debt	–	(0.19)	(0.47)
Cumulative effect of a change in accounting policy	**6.92**	–	–
Net income (loss) – U.S. GAAP	**$12.22**	$ 9.96	$(13.03)
Weighted average number of common shares outstanding *(millions)* – U.S. GAAP	**85.1**	84.9	80.4

(ii) Diluted earnings (loss) per share

U.S. GAAP requires the use of the treasury stock method for common stock equivalents to compute the weighted average number of common shares outstanding for the period. The use of the treasury stock method for the matched shares and stock options issued from 1995 to 1997 have been considered in the earnings per share figures for those years as computed under U.S. GAAP.

Year ended December 31	**1997**	1996	1995
Income (loss) from continuing operations – U.S. GAAP	**$ 5.44**	$ 9.88	$(12.64)
Discontinued operations	**(0.21)**	0.16	0.08
Extraordinary item – loss on extinguishment of long-term debt	–	(0.19)	(0.47)
Cumulative effect of a change in accounting policy	**6.83**	–	–
Net income (loss) – U.S. GAAP	**$12.06**	$ 9.85	$(13.03)
Weighted average number of common shares outstanding *(millions)* – U.S. GAAP	**86.2**	85.9	80.4

(iii) Pro-forma earnings (loss) per share

The following pro-forma earnings (loss) per share figures assume that the change in accounting policy for track replacement costs was applied retroactively.

Year ended December 31	**1997**	1996	1995
Basic earnings (loss) per share:			
Income (loss) from continuing operations – U.S. GAAP	**$ 5.51**	$ 4.43	$(17.88)
Net income (loss) – U.S. GAAP	**$ 5.30**	$ 4.40	$(18.27)
Diluted earnings (loss) per share:			
Income (loss) from continuing operations – U.S. GAAP	**$ 5.44**	$ 4.38	$(17.88)
Net income (loss) – U.S. GAAP	**$ 5.23**	$ 4.35	$(18.27)

(iv) Earnings (loss) per share (excluding special charges)

Earnings (loss) per share excluding special charges as disclosed in Note 16 would not be presented under U.S. GAAP.

C. Reconciliation of significant balance sheet items

(i) Employee share purchase loans

Amounts receivable under employee share purchase loans are included in Other current assets and Other assets and deferred charges for Canadian GAAP purposes. For U.S. GAAP purposes, these amounts would be classified as a reduction of Shareholders' equity.

(ii) Joint ventures

Interests in joint ventures are recognized using the proportionate consolidation method for Canadian GAAP. Under U.S. GAAP, joint ventures are accounted for using the equity method.

(iii) Shareholders' equity

As permitted under Canadian GAAP, the Company eliminated its accumulated deficit of $811 million as of June 30, 1995 through a reduction of the capital stock in the amount of $1,300 million, and created a contributed surplus of $489 million. Such a reorganization within shareholders' equity is not permitted under U.S. GAAP.

Under Canadian GAAP, the dividend in kind declared in 1995 (with respect to land transfers) and other capital transactions were deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Retained earnings.

Under Canadian GAAP, costs related to the sale of shares have been deducted from Contributed surplus. For U.S. GAAP purposes, these amounts would have been deducted from Capital stock.

(iv) The application of U.S. GAAP would have a significant effect on the following balance sheet items as reported:

In millions *December 31*	1997	1996
Current assets – Canadian GAAP	**$1,549**	$1,243
Joint ventures	**(15)**	(22)
Employee share purchase loans receivable	**(1)**	(10)
Current assets – U.S. GAAP	**$1,533**	$1,211
Properties – Canadian GAAP	**$5,122**	$4,869
Property capitalization, net of special charges and depreciation	**1,199**	–
Joint ventures	**(36)**	(57)
Other	**18**	18
Properties – U.S. GAAP	**$6,303**	$4,830
Deferred income tax asset – Canadian GAAP	**$ 164**	$ 522
Property capitalization	**(471)**	–
Income taxes on current year U.S. GAAP adjustments	**(40)**	–
Deferred income tax asset (liability) – U.S. GAAP	**$ (347)**	$ 522
Other assets and deferred charges – Canadian GAAP	**$ 240**	$ 206
Unrealized exchange loss on long-term debt	**(68)**	(24)
Joint ventures	**(4)**	22
Employee share purchase loans receivable	**(5)**	(6)
Other assets and deferred charges – U.S. GAAP	**$ 163**	$ 198

In millions *December 31*	1997	1996
Current liabilities – Canadian GAAP	**$1,205**	$1,233
Joint ventures and other	**(27)**	(1)
Current liabilities – U.S. GAAP	**$1,178**	$1,232
Other liabilities and deferred credits – Canadian GAAP	**$ 813**	$1,020
Stock-based compensation	**29**	14
Joint ventures and other	**(6)**	(6)
Other liabilities and deferred credits – U.S. GAAP	**$ 836**	$1,028
Long-term debt – Canadian GAAP	**$1,640**	$1,499
Joint ventures and other	**(12)**	(30)
Long-term debt – U.S. GAAP	**$1,628**	$1,469
Capital stock – Canadian GAAP	**$2,016**	$2,012
Capital reorganization	~~**1,300**~~	1,300
Employee share purchase loans receivable	**(6)**	(16)
Costs related to the sale of shares	~~**(33)**~~	(33)
Stock-based compensation	~~**2**~~	–
Capital stock – U.S. GAAP	**$3,279**	$3,263
Contributed surplus – Canadian GAAP	**$ 190**	$ 190
Capital reorganization	~~**(489)**~~	(489)
Dividend in kind with respect to land transfers	~~**248**~~	248
Costs related to the sale of shares	~~**33**~~	33
Other transactions and related income tax effect	~~**18**~~	18
Contributed surplus – U.S. GAAP	**$ –**	$ –
Retained earnings – Canadian GAAP	**$1,211**	$ 886
Capital reorganization	~~**(811)**~~	(811)
Dividend in kind with respect to land transfers	~~**(248)**~~	(248)
Other transactions and related income tax effect	~~**(18)**~~	(18)
Current year adjustments to net income	**637**	(4)
Cumulative effect of prior years' adjustments to income	**(40)**	(36)
Retained earnings (deficit) – U.S. GAAP	**$ 731**	$ (231)

20 Reconciliation of Canadian and United States generally accepted accounting principles *(continued)*

D. Pension costs and obligation

The disclosures required by Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions, are as follows:

(i) Assumptions

The following assumptions were used in determining the actuarial present value of the projected benefit obligation for U.S. GAAP:

Year ended December 31	**1997**	1996	1995
Discount rate	**6.50%**	7.50%	7.75%
Expected long-term salary increases	**4.50%**	4.50%	5.25%
Long-term rate of return on plan assets	**8.25%**	8.40%	7.75%

(ii) Components of annual pension expense

In millions Year ended December 31	**1997**	1996	1995
Service cost for benefits earned in the year	**$ 51**	$ 45	$ 47
Interest cost on projected obligation	**613**	611	586
Actual return on plans' assets	**(1,173)**	(1,392)	(926)
Net amortization and deferrals *	**550**	780	390
Pension expense – U.S. GAAP	**$ 41**	$ 44	$ 97

* *All experience gains (losses), including those in the 10% corridor are amortized.*

(iii) Funding status

In millions December 31	**1997**	1996
Actuarial present value of benefit obligation:		
Vested	**$8,278**	$7,672
Non-vested	**324**	268
	8,602	7,940
Effect of projected future salary increases	**549**	488
Projected benefit obligation	**9,151**	8,428
Pension fund assets at market value	**9,984**	9,279
Pension fund assets in excess of projected benefit obligation	**833**	851
Unamortized portion of net obligation at January 1, 1989 **	**122**	142
Unamortized prior service cost **	**9**	10
Unamortized net gain**	**(929)**	(994)
Prepaid pension expense – U.S. GAAP	**$ 35**	$ 9

*** Amortized on a straight-line basis over expected average remaining service lives of employees (15 years prior to 1991, 12 years from 1991 to 1994 and 11 years thereafter).*

E. Condensed U.S. GAAP Consolidated Income Statement and Balance Sheet

In millions Year ended December 31	**1997**	1996	1995
Total revenues	**$4,322**	$3,956	$ 3,912
Operating expenses excluding special charges	**3,395**	3,368	3,487
Special charges	**–**	365	1,415
Operating income (loss)	**927**	223	(990)
Interest expense	**(117)**	(113)	(194)
Other income	**24**	44	148
Income tax (expense) recovery from continuing operations	**(365)**	694	19
Income (loss) from continuing operations	**469**	848	(1,017)
Extraordinary item	**–**	(16)	(38)
Discontinued operations	**(18)**	14	7
Cumulative effect of change in accounting policy	**589**	–	–
Net income (loss)	**$1,040**	$ 846	$(1,048)

In millions December 31	**1997**	1996
Assets		
Current assets	**$1,533**	$1,211
Properties	**6,303**	4,830
Deferred income taxes	**–**	522
Other assets and deferred charges	**163**	198
Total assets	**$7,999**	$6,761
Liabilities and shareholders' equity		
Liabilities		
Current liabilities	**$1,178**	$1,232
Deferred income taxes	**347**	–
Other liabilities and deferred credits	**836**	1,028
Long-term debt	**1,628**	1,469
Shareholders' equity		
Capital stock	**3,279**	3,263
Retained earnings (deficit)	**731**	(231)
	4,010	3,032
Total liabilities and shareholders' equity	**$7,999**	$6,761

21 Comparative figures

Certain figures, previously reported for 1996 and 1995, have been reclassified to conform with the basis of presentation adopted in the current year.

22 Subsequent events

Proposed Canadian National – Illinois Central merger
In February 1998, the Company and Illinois Central Corporation (IC) entered into a merger agreement pursuant to which the Company would acquire all of the common stock of IC for a combination of cash and stock valued at U.S.$39.00 per share. IC has approximately 61.4 million shares outstanding giving the transaction a total equity value of U.S.$2.4 billion. The merger agreement was unanimously approved by the directors of both companies on February 10, 1998. Pursuant to the terms of the merger agreement, the Company commenced a cash tender offer on February 13, 1998 for approximately 46.1 million shares of IC common stock, representing approximately 75% of the outstanding IC common stock. The tender offer is subject to a minimum tender condition of 50.1% of the fully diluted IC common shares being validly tendered and not withdrawn. The tender offer will be subject to receipt of informal U.S. Surface Transportation Board (STB) staff approval of a required voting trust agreement and the satisfaction of other customary conditions.

The tender offer to acquire up to 75% of the common stock of IC will require the Company to disburse cash of approximately U.S.$1.8 billion which will be financed by a term loan facility (Term Facility) for U.S.$800 million and a revolving credit facility (Revolving Facility) for U.S.$1 billion. The Company anticipates that the facilities will be repaid from a variety of sources including funds generated internally, bank refinancings and the public or private sale of debt or equity securities. No final decisions have been made concerning the sources and methods employed to repay such indebtedness. Such decisions will be made and may be modified by the Company based on prevailing market conditions and such other factors as the Company may deem appropriate.

Following the completion of the tender offer, the Company will consummate the merger in which the remaining IC shares will be exchanged for cash and CN shares at a value equal to the same cash price paid in the tender offer, subject to certain collar arrangements. The merger is subject to, among other things, approval by IC shareholders and other customary conditions. All IC shares acquired by the Company in either the tender offer or merger will be placed in a voting trust. As such, the Company will not be able to exercise control over IC until the STB approves the Company's acquisition of control of IC. The STB could impose conditions or restrictions as it relates to the Company's acquisition of control of IC. If the STB does not approve the Company's acquisition of control of IC or if the Company deems any conditions imposed by the STB unacceptable, the Company would be obligated to sell all IC common shares held by the voting trust. Such a disposition could materially adversely affect the Company's financial condition and results of operations. Neither the acquisition of the IC shares pursuant to the tender offer nor the merger will be subject to STB approval of the combination.

Until STB approval, the Company will account for its investment in IC using the equity method. Upon receipt of STB approval, the transaction will be accounted for using the purchase method. Although the purchase price allocation will not be finalized until the STB renders its decision, initial estimates indicate that the purchase price will exceed the fair market value of the tangible assets to be acquired.

THE CN PENSION PLAN AND THE CN 1935 PENSION PLAN

General review

Trustee

Montreal Trust Company of Canada (Montreal Trust) is the Trustee of the Canadian National Railways Pension Trust Funds (CN Pension Trust Funds). As Trustee, Montreal Trust performs certain duties which include holding legal title to the assets of the Funds and ensuring that the Canadian National Railway Company (CN), as Administrator, complies with the provisions of the CN Pension Plan, the CN 1935 Pension Plan, and the Pension Benefits Standards Act, 1985 and its regulations. The cheques and direct deposit statements in respect of these plans are issued in the name of Montreal Trust, Trustee of the CN Pension Trust Funds.

Administration of the pension plans

Overall accountability for the pension and benefit administration is the responsibility of CN. William M. Mercer Limitée, an employee benefits consulting firm, performs agreed-on pension and benefit administration services on behalf of CN.

Indexation of pension benefits

As a result of the indexation agreement negotiated with the railway unions in 1989 and improvements to such agreement negotiated in 1992, approximately 42,000 retirees and surviving spouses received permanent pension increases in 1997. These increases amounted to 0.9% on the first $1,625 of the basic CN monthly pension, with a guaranteed minimum monthly pension increase of $9.00 for eligible retirees and $4.50 for eligible surviving spouses, respectively.

Under this indexation agreement, effective January 1, 1989, 50% of the experience gains or losses related to pensioners are accounted for separately. These net experience gains are used exclusively to pay for indexation of pensions above the minimum up to the maximum annual amount. The maximum annual indexation for eligible retirees and survivors is 50% of the increase in the Consumer Price Index (CPI) to a maximum increase in CPI of 6%, with an annual limit on the amount of pension which can be indexed. In 1997, the basic eligibility requirements to qualify for indexation were to have been retired for five complete calendar years and to have reached age 63.

Annual pension statements

As required by the Pension Benefits Standards Act, 1985 and to keep employees who are members updated annually on their personal entitlement, personalized pension statements were prepared as at December 31, 1996 and distributed by June 1997.

Services to pensioners

A. Direct deposit:

The Direct Deposit System (DDS) is available to all retirees and survivors. Under this system, the monthly pension benefit is deposited directly into the individual's personal account. An itemized pension pay stub is sent to that individual initially each January and whenever the gross or net amount changes. About 42,000 pensioners used this service in 1997.

B. Toll-free help lines:

Approximately 47,000 calls were handled in 1997 through the central toll-free help line (1-800-361-0739). Staff handling the toll-free telephone line have ready access to records and information required for quick, efficient and accurate responses to most callers' needs – in both of Canada's official languages.

Trustee's report

To the Administrator and the Members of the CN 1935 Pension Plan and the CN Pension Plan

We, Montreal Trust Company of Canada, are the Trustee of the Canadian National Railways Pension Trust Funds ("CN Pension Trust Funds").

As Trustee, we have appointed KPMG to examine the systems, procedures and internal controls used in respect to the custody, investment, and administration of the assets of the CN Pension Trust Funds, the administration of the CN 1935 Pension Plan ("1935 Plan") and the CN Pension Plan, and the performance of Canadian National Railway Company ("CN") as Administrator of the 1935 Plan and the CN Pension Plan for the year ended December 31, 1997.

Our examination included such tests and procedures as were considered necessary in the circumstances taking into consideration the requirements of the Trust Deeds and our experience in the Canadian pension industry.

In our opinion, based on the reasonable, but not absolute, degree of assurance obtained from the examination performed, the aforementioned systems, procedures and internal controls, used by CN as Administrator, operated effectively during the year ended December 31, 1997, and complied with the objectives of the Pension Benefits Standards Act, 1985 and its Regulations.

Montreal Trust Company of Canada
Trustee of the Canadian National Railways
Pension Trust Funds

Montreal, January 20, 1998

Actuary's report

To the Trustee
Canadian National Railways Pension Trust Funds

We have conducted actuarial valuations as at December 31, 1996 for the CN Pension Plan and the CN 1935 Pension Plan.

As at December 31, 1996, these valuations revealed a consolidated actuarial liability of $8,192 million, a consolidated unfunded actuarial liability of $101 million and required consolidated Company contributions representing $63 million in 1997. The next actuarial valuations will be conducted as at December 31, 1999, at the latest.

In my opinion, for the purposes of the valuations,

- the data on which these valuations were based were sufficient and reliable,
- the assumptions are, in aggregate, appropriate; and
- the methods employed in the valuations are appropriate.

The valuations have been prepared, and my opinions given, in accordance with accepted actuarial practice.

Bernard Morency
Fellow of the Canadian Institute of Actuaries
William M. Mercer Limitée

Montreal, January 20, 1998

Auditor's report

To the Board of Directors

We have audited the consolidated statement of net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1997, and the consolidated statement of changes in net assets for the year then ended. These financial statements are the responsibility of the Administrator. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Administrator, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the net assets of the CN Pension Plan and the CN 1935 Pension Plan as at December 31, 1997, and the changes in their net assets for the year then ended in accordance with generally accepted accounting principles.

KPMG
KPMG
Chartered Accountants

Montreal, Canada
January 20, 1998

CONSOLIDATED STATEMENT OF NET ASSETS AT MARKET VALUE

In millions	*As at December 31*	**1997**	1996
Bonds		**$3,645**	$3,008
Mortgages		**109**	119
Real estate		**465**	384
Oil and gas		**229**	222
Equities		**4,810**	4,491
Cash and short-term investments		**633**	974
		9,891	9,198
Accounts receivable – Canadian National Railway Company		**5**	6
Other liabilities		**(22)**	(20)
		$9,874	$9,184

See accompanying notes to consolidated financial statements.

On behalf of the board:

David G.A. McLean
Director

Paul M. Tellier
Director

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS AT MARKET VALUE

In millions *Year ended December 31*	**1997**	1996
Net assets at market value, beginning of year	**$9,184**	$8,299
Investment income		
Bonds	**224**	229
Mortgages	**10**	9
Real estate	**12**	13
Oil and gas	**18**	28
Equities	**101**	71
Short-term investments	**24**	46
	389	396
Less administrative expenses	**(10)**	(9)
Investment income before gains on sales of investments	**379**	387
Gains on sales of investments	**527**	431
Total investment income	**906**	818
Unrealized appreciation in value of investments	**249**	565
Contributions		
Employees	**77**	79
Company	**63**	79
Total contributions	**140**	158
Disbursements for members		
Pension benefits paid	**(554)**	(548)
Refunds	**(47)**	(70)
Total disbursements for members	**(601)**	(618)
Transfers	**(4)**	(38)
Net increase	**690**	885
Net assets at market value, end of year	**$9,874**	$9,184

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Description of plans

These consolidated financial statements cover two pension plans, the CN Pension Plan and the CN 1935 Pension Plan (CN Plans), and include the accounts of the Canadian National Railways Pension Trust Funds and its wholly owned companies. All references in these financial statements to the "Company" refer to Canadian National Railway Company, which is the Administrator of the CN Plans. The CN 1935 Pension Plan is for a closed group of members and represents less than 1% of the pension obligation of the plans. Therefore, the following is a summarized description of the CN Pension Plan only. Please refer to the rules of the CN Pension Plan for additional information.

A. General

The CN Pension Plan (Plan) is a contributory defined benefit pension plan generally applicable for new employees from the first day of employment. Under this Plan, employees contribute between 5.48% and 5.88% of earnings up to the Year's Maximum Pensionable Earnings (YMPE) under the Canada or Quebec Pension Plan and between 6.98% and 7.38% of earnings in excess of the YMPE up to a maximum of $6,322 in 1997. Participants are not required to make contributions after 35 years of pensionable service. Company contributions are determined on the basis of actuarial valuations done at least on a triennial basis in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder.

B. Pensions

Pensions are based on the employee's average pensionable earnings for the best five consecutive calendar years or the last 60 months of employment at the rate of 2% for each year of pensionable service prior to January 1, 1966, 1.3% for each year of pensionable service thereafter up to the average YMPE over the last 60 months, and 2% of the excess of such average pensionable earnings over the average YMPE. The maximum annual pension payable is $1,715 multiplied by the pensionable service of the member. Pensionable service is limited to 35 years.

C. Retirement age

The normal retirement age is 65. However, employees with 85 points (age plus pensionable service) and with the Company's consent are entitled to an early retirement pension without reduction as long as they are at least 55 years of age. Furthermore, employees with less than 85 points can retire anytime from age 55 with a reduction in their pension of 0.5% for each month (6% per year) between their date of retirement and their 65th birthday.

D. Disability pensions

A member with 10 years of pensionable service who is either declared unfit to perform his (her) usual employment with the Company due to a permanent disability which occurred prior to 1992, or is declared totally and permanently disabled due to a disability which occurred after 1991, may apply for an immediate unreduced pension. Any declarations in respect of a member's disability are the responsibility of CN's System Director of Occupational Health Services.

E. Pre-retirement survivors' pensions and death refunds

A survivor's pension is payable to the eligible spouse of a member who had a minimum of two years of plan membership upon his (her) death. Otherwise, a death refund is payable to the spouse, or, if there is no spouse, to the estate of the member.

F. Post-retirement survivors' pensions and estate settlements

Upon death of a retiree who had an eligible spouse at retirement, either 50% or 60% of the basic pension of the retiree is payable to that spouse during his (her) lifetime depending on the option elected at retirement. The survivor pension is guaranteed for the first 10 years after retirement. If the retiree and the surviving spouse, if any, die in the first 10 years after retirement, the survivor pension will be payable to the estate of the retiree until the 10-year period is over.

1 Description of plans *(continued)*

G. Termination benefits

Upon termination of service, a member is entitled to either his (her) contributions with interest or to the value of his (her) benefits accrued under the plan or to a deferred pension or a combination of the above, depending on his (her) age, pensionable service and years of membership at termination.

H. Income taxes

The Plan is registered under the Income Tax Act and regulations. Contributions to the Plan are tax deductible and investment income of the Canadian National Railways Pension Trust Funds is not taxable in Canada. Investment income from some foreign countries is subject to withholding taxes which are either fully or partially recovered.

2 Summary of significant accounting policies

A. Basis of presentation

These consolidated financial statements are prepared on a market value basis, in accordance with generally accepted accounting principles for pension plans as recommended by the Canadian Institute of Chartered Accountants and present the aggregate financial position of the CN Plans as a separate financial reporting entity independent of the sponsor and plan members. The statements are prepared to assist plan members and others in reviewing the activities of the CN Plans for the year but they do not portray the funding requirements of the plans or the benefit security of individual members.

B. Valuation of net assets

Market value is determined using publicly quoted prices where available. When such prices are not available, market values are estimated on the basis of: the present value of estimated future cash flows, the market value of comparable assets, or the breakup value of underlying assets.

Valuation of net assets by category is as follows:

(i) Bonds are valued using the closing market bid as at December 31.

(ii) Mortgages are valued using current market yields of financial instruments of similar maturity and at appropriate spreads from instruments of comparable quality.

(iii) Real Estate consists of land, buildings, and equities. Land is valued using the market value of comparable assets, and buildings are valued using the present value of estimated future cash flows and the market value of comparable assets. Independent valuations of land and buildings are performed triennially. Equities are valued using closing market quotations as at December 31.

(iv) Oil and gas reserves are valued using the present value of estimated future net cash flows, which are based on projected production, prices, and costs. Land is valued using the market value of comparable assets. Trust units are valued using the closing market price as at December 31.

(v) Equities are valued using the closing market price as at December 31.

(vi) Short-term investments are valued at cost which approximates market value.

(vii) Listed derivative financial instruments are valued using the market settlement price as at December 31. Unlisted derivative financial instruments are valued using the present value of future cash flows determined by using closing market levels and interest rates for instruments of similar maturity and credit risk.

C. Income recognition

Dividends are accrued on the ex-dividend date; income from other investments is accrued as earned. Gains or losses on sales of investments are recognized on the dates of sales and are calculated on the basis of the average cost of the assets.

D. Foreign exchange
Investments denominated in foreign currencies are translated using current rates as at December 31 or at the forward foreign exchange contract rates for investments that are hedged. Foreign dividends and interest income are translated at the rates prevailing when accrued.

E. Change in market value
The change in market value has been segregated in the consolidated statement of changes in net assets between gains or losses on the sales of investments during the year and the unrealized appreciation (depreciation) in the value of investments, which is the balance of the change in market value of investments for the year.

F. Contributions
Contributions from employees are recorded in the period in which the Company makes payroll deductions. The contributions from the Company, as determined by the latest actuarial valuations, are recorded using the accrual method.

G. Transfers
Transfers to/from other funds are accounted for in the period in which the value of the transfers can be reasonably estimated.

3 Investments

All investments are securities, assets or financial instruments where the plans' original intention is to hold to maturity or until market conditions render alternative investments more attractive. Significant terms and conditions of investments are as follows:

Bonds, 80% (77% in 1996) of which are issued or guaranteed by Canadian or U.S. governments and 14% (19% in 1996) are issued by supranational agencies, have a market weighted average coupon of 7.9% (8.6% in 1996). Maximum term is 29 years (28 years in 1996) with an average term of 10.7 years (8.4 years in 1996).

Mortgages, secured by real estate, have a market weighted average coupon of 10.9% (9.9% in 1996). Maximum term is 14 years (15 years in 1996) with an average term of 9.5 years (9.5 years in 1996).

Equities are diversified by issuer, industry and by country. Canadian domiciled companies represent 57% (53% in 1996) of the equity portfolio and allocations to individual issuers or industry sectors are limited to 3.5% and 10.2% (2.9%, and 9.9% in 1996) respectively.

Short-term investments, primarily securities issued by the Government of Canada and Canadian chartered banks, have an average term of 6 days (38 days in 1996) and an average yield of 4.5% (2.8% in 1996).

Derivatives are financial instruments whose value is derived from interest rates, foreign exchange rates, equity or commodity prices. Derivatives include forwards, futures, swaps and options.

From time to time the CN plans use derivatives in connection with their asset/liability management to hedge foreign exchange, interest rate or market risks of the portfolio or anticipated transactions.

Notional amounts of derivative contracts were as follows:

In millions *As at December 31*	**1997**	1996
Foreign currency risk	**$526**	$178

The weighted average term of the above contracts was 2 years (2.6 years in 1996). The value of derivative instruments is $(3) million ($2 million in 1996) and is included in the value of bonds, which is the asset class hedged.

4 Credit risk

Credit risk arises from the potential for an investee to fail or a counterparty to default on its contractual obligations to the plans.

In accordance with formally established policies, the plans manage credit risk by dealing with counterparties considered to be of high credit quality, utilizing an internal credit limit monitoring process as well as credit mitigation techniques such as master netting and collateral agreements.

4 Credit risk *(continued)*

At year end, the plans' most significant concentration of credit risk was with the Government of Canada which issued or guaranteed $2,493 million ($2,839 million in 1996) of securities held by the plans. Excluding the above, the remainder of assets are diversified with no other counterparty accounting for more than 2.2% (2.1% in 1996) of total net assets.

The credit risk of derivative instruments is limited to the cost of replacing, at current market value, all contracts which have a positive value. The following table shows the credit risk of all derivative instruments outstanding at year end.

Credit risk – Derivative instruments

In millions *As at December 31*	**1997**	1996
Maximum exposure	**$ 1**	$ 6
Less effect of master netting and collateral agreements	–	(6)
Net credit risk	**$ 1**	$ –

5 Funding policy

In respect of the CN Plans, the contributions by the Company are determined in accordance with the requirements of the Pension Benefits Standards Act, 1985 and regulations thereunder, and are based on the accrued benefit actuarial cost method, prorated on service, using a projection of salary (also referred to as the projected benefit method prorated on years of service). Consistent with the regulations and in addition to the current service contribution, the Company is making quarterly special payments to liquidate the unfunded actuarial liability by 2010. Also, in the case of the CN 1935 Pension Plan, the Company makes money purchase contributions in accordance with the rules of the plan.

The latest actuarial valuations of the CN Plans were prepared by William M. Mercer Limitée as at December 31, 1996 and were submitted to the Superintendent of Financial Institutions and to Revenue Canada. In these actuarial valuations, the principal assumptions adopted by the Plans' actuary are: members' mortality, disability, retirement, termination of employment, merit and periodic increases in earnings, as well as a long-term rate of return of 7.5% per annum on investments. Future increases in members' earnings have been projected using economic assumptions consistent with this long-term rate of return.

6 Transfers

In 1997, the accounts include a provision for the amounts to be remitted to/from other funds to cover transfers of members of CN Plans to other pension plans and transfers of members of other plans to the CN Plans.

7 Consolidated actuarial pension obligation and asset value

The actuarial valuations as at December 31, 1996, revealed a consolidated actuarial liability of $8,192 million and a consolidated actuarial asset value of $8,091 million. The results of these valuations were then used to estimate the corresponding figures as at December 31, 1997, which approximate $8,440 million and $8,580 million respectively as at that date. The principal components of the change in the pension obligations are the interest accrued on benefits ($600 million in 1997 and 1996), disbursements paid for members ($601 million in 1997 and $618 million in 1996) and benefits accrued during the year ($250 million in 1997 and $130 million in 1996). The consolidated actuarial asset value is based on a market-related method which recognizes the change in market value over a period of 5 years using the straight-line method.

BOARD OF DIRECTORS

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Canadian National Railway Company
Chairman and Chief Executive Officer
The McLean Group
Vancouver, BC
Committees: 2*, 3, 5, 6, 7

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Limited Partner
The Goldman Sachs Group
New York, NY
Committees: 1, 6, 7

Purdy Crawford, O.C., Q.C., LL.D.
Chairman
Imasco Limited
Toronto, ON
Committees: 2, 5*, 6, 7

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Chairman
Telesat Canada and
SSIG Group Inc.
Montreal, QC
Committees: 1, 4*, 7

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Chairman and Chief Executive Officer
Canadian Hunter Exploration Ltd.
Calgary, AB
Committees: 4, 5

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General Motors of Canada Limited
Toronto, ON
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Tryton Investment Company Limited
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Assumption Life
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Committees: 2, 6

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Toronto, ON
Committees: 2, 7

Dr. Edward P. Neufeld
Economist
Mississauga, ON
Committees: 4, 7

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The Pace Group
Halifax, NS
Committees: 1*, 4, 5

Cedric E. Ritchie, O.C., LL.D.
Corporate Director and Former Chairman
and Chief Executive Officer
The Bank of Nova Scotia
Toronto, ON
Committees: 1, 2, 6, 7*

Paul M. Tellier, P.C., C.C., Q.C., LL.D.
President and Chief Executive Officer
Canadian National Railway Company
Montreal, QC
Committees: 3*, 7

Committees:

1 Audit and finance
2 Corporate governance
3 Donations
4 Environment and safety
5 Human resources
6 Investment
7 Strategic planning

*denotes chairman of the committee

OFFICERS OF THE COMPANY

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Chairman

Paul M. Tellier
President and Chief Executive Officer

Gerald K. Davies
Executive Vice-President
Marketing

Robert F. Dolan
Senior Vice-President
Corporate Services

Keith L. Heller
Senior Vice-President
Line Operations

Jack T. McBain
Executive Vice-President
Operations

Jean Pierre Ouellet
Chief Legal Officer and
Corporate Secretary

Michael J. Sabia
Executive Vice-President and
Chief Financial Officer

Tullio Cedraschi
President and
Chief Executive Officer
CN Investment Division

André Couture
Vice-President
Corporate Development and
Special Projects

Sean Finn
Treasurer and
Principal Tax Counsel

James M. Foote
Vice-President
Merchandise

Gary L. Gibson
Vice-President
Risk Management

Fred R. Grigsby
Vice-President and
Chief Information Officer

Wes T. Kelley
Vice-President
Public Affairs and Advertising

S. Craig Littzen
Vice-President
Intermodal and Automotive

Peter C. Marshall
Vice-President
Bulk Commodities

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Vice-President
Operations Planning

Sandi J. Mielitz
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Vice-President
Transportation

David E. Todd
Vice-President
Government Affairs

Frank J. Trotter
President and
Chief Executive Officer
Canac Inc.

Dennis E. Waller
Vice-President
Mechanical

Annual meeting
The annual meeting of shareholders will be held from 10:30 a.m. to 11:45 a.m. on Tuesday, April 28, 1998, at The Winnipeg Convention Centre, Winnipeg, Manitoba.

Annual information form
The annual information form may be obtained by writing to:

The Corporate Secretary
Canadian National Railway Company
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9

Transfer agent and registrar
Montreal Trust Company of Canada

Offices in:
Halifax, NS; Montreal, QC; Toronto, ON; Winnipeg, MB; Calgary, AB; Edmonton, AB; Vancouver, BC

Co-transfer agent and co-registrar
The Bank of Nova Scotia Trust Company of New York
165 Broadway
1 Liberty Plaza
New York, NY 10006

U.S. cash dividend plan
Shareholders wishing to receive dividends in U.S. dollars may obtain detailed information by communicating with:

Montreal Trust Company of Canada
Telephone: (514) 982-7555 or 1-800-527-2221

Stock exchanges
Canadian National common shares are listed on the Toronto, New York and Montreal stock exchanges.

Ticker symbols:
CNR (Toronto stock exchange)
CNI (New York stock exchange)
CNR (Montreal stock exchange)

Investor relations
Robert Noorigian
Vice-President, Investor Relations
Telephone: (514) 399-0052

Shareholder services
Shareholders having inquiries concerning their shares or wishing to obtain information about CN should contact:

Montreal Trust Company of Canada
Shareholder Services
1800 McGill College Avenue
Place Montreal Trust, 6th Floor
Montreal, Quebec H3A 3K9
Telephone: (514) 982-7555 or 1-800-527-2221

Head office
Canadian National Railway Company
935 de La Gauchetière Street West
Montreal, Quebec H3B 2M9

P.O. Box 8100
Montreal, Quebec H3C 3N4

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